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THE INFORMAL FINANCIAL SECTOR: WHAT FORMS IT CONTAINS AND WHO ARE THE CUSTOMERS?

J.J. Thomas

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THE INFORMAL FINANCIAL SECTOR: HOW DOES IT OPERATE AND WHO ARE THE CUSTOMERS?

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Preface and Acknowledgements

ODI *Working Papers* present in preliminary form work resulting from research undertaken under the auspices of the Institute. Views expressed are those of the authors and do not necessarily reflect the views of ODI. Comments are welcomed and should be addressed directly to the author.

This *Working Paper* is one of several prepared as part of a study of the role of monetary policy in primary product-dependent, low-income countries. The objective of the study is to examine what monetary policy can be expected to accomplish and the principal constraints upon its effectiveness. Six country studies (Bangladesh, China, Côte d'Ivoire, Ghana, Indonesia and Kenya) examine the development of monetary institutions, the determination of money supply and demand, and the objectives and experience of governments in implementing monetary policy in individual countries. The final report is expected to be published in 1992. The project is directed at ODI by Sheila Page. We are grateful for financial support from the Overseas Development Administration, the Rockefeller Foundation and the International Development Research Centre of Canada.

Jim Thomas is a Senior Lecturer at the London School of Economics and was a Research Associate of ODI as a participant in the project described above. The author would like to thank John P. Caskey and Sheila Page for detailed comments on an earlier draft and the participants in the ODI/HIID Conference on *Improving Monetary Management in Africa and Asia* (London, 9-11 September 1991) for helpful discussion. The views expressed here are the author's and should not be attributed to either ODI or HIID.

CONTENTS

I. INTRODUCTION

The discussion of monetary policy elsewhere in this study has concentrated on the formal financial sector (FFS), that is the commercial banks and various specialised financial institutions created and licensed by the governments in many developing countries to target long-term investment to particular regions or groups. While the formal financial sector undoubtedly plays an important role in the operation of monetary policy, the picture would be incomplete without some consideration of the informal financial sector (IFS) that exists in developing countries. However, in the literature of development economics, 'financial dualism' has involved more than simply the dichotomy between FFS and IFS, since the customers of the institutions in the FFS and IFS are also dichotomised to produce a 'double duality'. Thus:

> *The financial systems of most developing countries are characterised by the co-existence and operation side by side of a formal financial sector and an informal financial sector - a situation commonly denoted as "financial dualism". Theoretically, the formal sector would refer to an organised urban-oriented, institutional system catering to the financial needs of the modernised modern sector, while the informal sector, itself unorganised and non-institutional, would deal with the traditional, rural, subsistence (non-monetised) spheres of the economy.* (Germidis, Kessler and Meghir 1991, p. 13.)

In this context, the discussion has been concerned with whether the IFS exists because of 'financial repression' caused by distortion in the FFS, or whether the FFS is adversely affected by structural distortions in the economy that provide support for the IFS. This 'double dualism' may be criticised from a number of points of view (see Thomas 1991), but of relevance here is the omission of sectors that are important in developing countries. First, while in general the customers of the FFS tend to be in the modern (or formal) sector of large-scale industrial and manufacturing production, there are also rural customers in modern agricultural sector. Second, while in general there is little contact between the FFS and potential customers in the rural traditional sector (RTS), this is also true for potential customers in the urban informal sector (UIS). As a result, the concentration on the FFS tends to ignore the financial needs of two important groups; those working in the urban informal sector[1] and the rural poor; groups that represent a high proportion of the population in most developing countries.[2] The fact that the needs of these groups are not generally catered for by the FFS has meant that informal financial institutions (IFIs) have played an important role in supplying these needs.[3]

The FFS in most developing countries offers the basic services of money transfers, chequing services, credit cards, facilities for saving and the provision of credit. Why are these services not available to potential customers in the RTS and UIS? There are six main reasons; (i) the commercial banks do not have branches in the city slums and squatter settlements or outside towns in the countryside, so easy access to banking facilities by potential customers is limited, (ii) commercial banks are inflexible and tend to grant credit only for investment purposes and not for consumption, (iii) transactions costs are high, since the size of potential transactions

are small, and may become very high if they include adequate project appraisal (iv) the commercial banks lack information about potential customers from these groups, so that checking on creditworthiness is both difficult and costly, (v) potential customers do not possess acceptable collateral to substitute for creditworthiness, and (vi) given the lack of information about these customers, it is believed that they are too poor to be able to pay a commercial rate of interest on a loan.

The main purpose of this *Working Paper* will be to examine in more detail the response of formal financial institutions (FFIs), often in reaction to government or international persuasion, to the problems listed in the previous paragraph and the extent to which institutions in the IFS are able to overcome these problems and provide financial services to the RTS and UIS. The next section will present some evidence on the small scale of the involvement of the FFS in the UIS and some of the causes of the problems listed above. Section III will discuss a variety of informal financial institutions and examine how successful they have been in overcoming the problems. Section IV will consider the implications of the IFS for monetary policy, while Section V will present some conclusions.

II. FORMAL FINANCIAL INSTITUTIONS AND THE RURAL TRADITIONAL AND URBAN INFORMAL SECTORS

In order to interpret evidence on the extent to which commercial banks and the rest of the FFS (i) do or (ii) could cater to the needs of the rural and urban informal sectors, one must compare the services offered by the commercial banks with the needs of those working in the RTS and UIS.[4] The services normally provided by commercial banks are threefold, money transfers, often through the provision of chequing facilities, opportunities for saving and the provision of credit for private or business purposes.

The answer to the question of what services the FFS does provide to the UIS is - not many, since these services are not well matched with the needs of the RTS and UIS. While some small enterprises and some farmers may be sufficiently well-established to make regular use of commercial banking facilities, the majority of those working in the RTS and UIS do not make use of the system. The majority of those in the UIS tend to operate with cash, since their incomes are low and they are dealing with or selling to people who do not have bank accounts, so the advantages of a bank account for trade are not obvious, except to put the individual in touch with other bank services. At the subsistence level at which many peasants operate, many have little regular contact with markets and do not need to use cash as much as those in the urban context.

There is also a problem of distance, since most commercial banks are physically distant from many potential rural customers, who are too poor to travel to the local towns or cities to make use of bank services. For the UIS, it is 'social' rather than 'physical' distance that is the problem, since many of the slums or squatter settlements they inhabit are close to the downtown offices of the commercial banks, but such is the bad reputation of the UIS that few bank managers would contemplate sending their employees to these areas or opening branch offices.

This absence of contact with commercial banks tends to mean that where saving is possible, it will be undertaken through other channels and this is one important service that is provided by some institutions in the IFS. In addition to the absence of links with commercial and other banks through normal banking activities, the small size of increments of savings and the relatively short saving periods involved tends to make saving through the FFS both difficult and unattractive. Within the RTS and UIS, some saving is of the precautionary (rainy day) variety, which may need to be liquidated frequently, while some is intended to build up capital.

The needs for credit for those in the RTS and UIS are very diverse, ranging from needs to cover seasonal fluctuations in income flows, through the provision of short-term liquidity to the supply working capital and funds for investment. For example, among the poor with little or no precautionary savings, or those who are somewhat better off but suffer unusual misfortunes, there is a need for emergency credit. In addition, many working in agriculture, especially those producing an annual crop, need credit to smooth consumption flows given the peaked seasonality in their incomes. Others seek credit for business purposes, either as

working capital for the purchase of raw materials or agricultural seeds, or for investment in plant and machinery.

Whatever the reasons, it is clear that those working in the UIS do not receive much credit from the FFS. For example, in a large scale study of the UIS in Lima, Carbonetto, Hoyle and Tueros (1987) investigated the sources of credit available to members of the sample. They found that 91% of those working in the UIS had not obtained any credit and an additional 2.6% had obtained credit of less than US$10. Of those who had obtained credit, only 5.6% received loans from commercial banks and 6.3% from state banks, whereas 41.7% obtained loans from parents or friends. Less than 1% had taken loans from moneylenders for very short periods (from one day to a week) at real interest rates of 40% to 70% per annum. Chandavarkar (1989) cites data for a number of African countries showing that the initial investment for the start-up of small enterprises came overwhelmingly from the entrepreneur's own savings or those of relatives and at most 2% came from banks (see also Harper 1984, chapter 5).

There are two main reasons why the financial sector does not supply credit to the rural and UISs. The first is that the quantities of credit required by a majority of potential borrowers from these sectors may be too small to cover the fixed costs involved in making individual loans. For example, Levitsky (1986b) quotes studies of the Philippines in the 1970s showing that the transactions costs in lending to small businesses were between 2.5% and 3.0% of the value of the loan, as compared to 0.5% of loans to large businesses. Bundling savings or loans into larger units is one methods of reducing the effect of high fixed costs, but bundling is not a costless process. Some ways of dealing with this problem will be discussed in the next section.

The second is the problem of assessing risk and this presents particular difficulties. Here again the lack of customer contact with the commercial banks by most of those working in the RTS and UIS works against them as they cannot build up a creditworthy reputation with the lending institution. The possibility of supplying collateral as a substitute for reputation is also denied to most of them, since they do not possess the necessary assets. Many working in the UIS live in slums or as squatters on land that has been acquired illegally or to which they have no title. This removes one possible source of collateral that is used extensively by those operating in the formal sector.[5] Even where small enterprises own capital in the form of machinery, it is often obsolescent and of little market value and so is of little use as collateral. In the absence of credit from the commercial banks, those working in the RTS and UIS have had to turn to other sources and institutions, which will be discussed in the next section.

In assessing the extent to which the FFS could cater for the financial needs of the RTS and UIS, the provision of chequing facilities is probably of least concern, since the absence of these facilities impinge less on those working in these sectors than the absence of savings and credit facilities. Here the high fixed costs of small transactions and the problems of assessing risk and lack of collateral represent major obstacles to progress. Commercial banks and other financial institutions may well feel that they do not need this business. However, policy makers in many developing countries have long been concerned with the problem of providing rural credit and some have taken a more positive view of the UIS and wished to

encourage its development. As a result there have been efforts to involve the FFS, through funding from state banks, credit guarantee programmes and the creation of special banks.

Credit guarantee schemes. One method of making loans made on the basis of little or no collateral more attractive to formal financial institutions is to provide credit guarantees against default. This has been tried in a large number of countries, both developed and developing, with somewhat mixed success. Levitsky and Prasad (1987) explain:

> *The purpose of such schemes is to encourage financial institutions, and in particular commercial banks, to lend to small businesses with viable projects and good prospects of success but which are unable to provide adequate collateral or which do not have a suitable record of financial transactions to prove that they are creditworthy.* (p. 1).

While the basic idea is simple, success depends on ensuring a number of conditions are satisfied. First, while the objective is to reduce the risk of certain kinds of loans, the guarantees should not remove risk altogether. If the lending banks bear none of the risk, they will have little or no incentive to assess the viability of the loans made under the scheme, which is then likely to run into financial problems by having to pay out its initial capital quickly in default payments. This consideration affects the percentage of the loan (the principle and possibly interest payments) covered by the guarantee. This should be large enough to make the scheme attractive to commercial banks, while not so large as to discourage proper profit appraisal. With the exception of Japan, where 100% credit guarantees are offered and seem to work, in many countries the maximum cover is around 60%.

Second, the scheme must ensure that proper evaluations of viability are carried out and this raises the question of who is to do it. One argument is that the commercial banks should do it, since they are making the loan. However, in some cases, participating commercial banks will be dealing with new kinds of customers and may not have the expertise to assess projects and there may be a case for the agency providing the credit guarantee to charge a fee and provide the necessary evaluation. It is important that an assessment should be made, but in a well-designed scheme it should not be necessary for both to carry out a study of viability. It is important that charges should be high enough to cover these evaluation costs as a number of credit guarantee schemes ran into problems on this matter. As was shown above, borrowers in the rural and UISs have been able to repay loans plus interest rates above those charged in the FFS, so a fee sufficient to ensure proper assessment of viability should not affect the acceptability of the scheme.

Third, the scheme should lay out explicitly and clearly the evaluation criteria to be followed by commercial banks if they are responsible for the viability assessment, to prevent problems arising later when defaults occur if claims are rejected because the commercial banks failed to meet unclear or implicit requirements for project evaluation.

Fourth, the conditions to be met before a claim is accepted need to balance sufficient generosity to encourage the commercial banks to participate with the need to ensure this generosity does not discourage the banks from pursuing bad debts with all possible vigour before making a claim. The requirements need to be spelled out explicitly at the outset and

not be the subject of conflict between the guarantee agency and the banks when claims start to be made.

Fifth, once claims are submitted and are found to be valid, it is necessary to ensure prompt settlement. There is evidence from a number of countries that scepticism about the probability of guarantees being met or bad experiences with delays over settlement of claims have been the main causes of commercial banks either refusing to participate in credit guarantee schemes or to leave them having joined.[6]

Sixth, it is necessary to balance the ratio of guarantees to the credit guarantee agency's capital to provide as many guarantees as possible consistent with ensuring that the fund is sufficient to cover probable claims. Levitsky and Prasad suggest that a ratio of a total value of guarantees to the capital fund of about 10:1 is appropriate for most developing countries.[7]

Seventh, the scheme should induce the banks to make loans they would not otherwise have made (that is, provide additionality), rather than allowing the participating banks to obtain credit guarantees for risky loans they would have made anyway. Additionality is often difficult to achieve and Levitsky and Prasad report that in many of the countries they studied, participating banks continued to demand collateral even where credit guarantees should have provided adequate protection.

Finally, there is the problem of making the schemes attractive to participating banks, unless the problem of covering high transaction costs is solved. Reporting on problems with a scheme in Barbados, Levitsky and Prasad noted hostility from potential participants on the grounds that 'the commercial banks regard the scheme as a way of making them approve loans to very risky small businesses. In addition, the commercial banks are not very enthusiastic about granting small loans on which the risks are high and the profitability is low. They prefer to make larger loans where the risks are high but the profitability is higher.' (p. 79). This problem may be particularly severe when the credit guarantee scheme tries to provide credit at subsidised low interest rates, since this may not provide sufficient spread for the banks to make a profit.

The survey by Levitsky and Prasad finds evidence of major problems facing credit guarantee schemes in many of the countries they studied and few schemes met most of the criteria listed above. The most frequent problems were failure to lay out the risk assessment criteria clearly, with considerable disputes between the participating banks and the agency running the scheme and slow settlement rates. In a some instances the number of guarantees being issued dropped sharply after an initial growth as the participating banks either withdrew or simply cut back on the number of applications they put forward. In others the schemes became unviable when faced with high default rates and were unable to continue.[8]

The authors conclude:

> *Credit guarantee schemes appear to be an attractive form of support for small enterprise development in developing countries, where non-availability of finance has been a serious constrain in developing the small business sector. However, guarantee schemes only have meaning to the extent that the commercial banking system is ready to participate in the scheme. Schemes in*

> *which the only participants are publicly-funded development finance institutions have little meaning, since ultimately the losses of these institutions must be made good from the public treasury. The evidence from developed countries is that the government, the business community, and the banking system must all assume some part of the risk. Credit guarantee schemes cannot and should not completely absolve banks from taking a normal level of risk as such risk-taking is acceptable banking practice.* (p. 13).

While the practical record of many credit guarantee schemes has not been outstanding in many developing countries, its success in a number of developed countries suggests that the basic approach does not suffer from major flaws and that detailed analysis of the problems in particular countries may enable new schemes to avoid some of the pitfalls. The credit guarantee scheme has the advantage of persuading the FFS to participate and may therefore be more flexible and responsive than more direct approaches that ignore this sector.[9] Alternative approaches might involve acting as a broker between the informal and formal financial sectors. While such approaches have not been widely tried to date, Seibel (1989) and Seibel and Parhusip (1990) report on interesting experiments in the Philippines and a number of other countries with financial self-help groups acting as intermediaries between microentrepreneurs and commercial banks. These schemes deserve further study as their potential for providing credit to the poor is clearly important.

The reluctance of the FFS to become involved in schemes aimed at small-scale enterprises (SSEs) is illustrated by the experience of the World Bank. During the late 1970s, the World Bank accepted the case for supporting SSEs because of their potential for job creation. Between July 1977 and June 1985, it lent more than US$2.2 billion through 70 different projects in 37 countries. Even though the SSEs involved in the World Bank programmes were being loaned amounts in the range of US$20,000 to US$50,000 and were thus much larger financially than most small enterprises in the UIS, the Bank had difficulties in finding appropriate financial intermediaries for its programmes. In its early projects, the funds were channelled through Development Finance Companies (DFCs), but these were found to be too centralised, with few branches outside the metropolitan centres, and, conditioned by their role in appraising complex projects, they demanded extensive documented information, which could not be provided by small enterprises.

Given these problems, the World Bank switched its policy towards channelling its credit through the commercial banks. Levitsky (1986a) reports on the advantages of using these institutions, since:

> *(i) they have the necessary domestic resources and as such are better able to meet the need for working capital and term loans for fixed assets;*
>
> *(ii) they offer a greater variety of banking services;*
>
> *(iii) they usually have a large branch network permitting contact with small enterprises on a local basis;*
>
> *(iv) they are better able to respond quickly to the needs of small businesses; and*

(v) they are more experienced in debt collection than the DFCs. (p. 20)

However, despite these advantages, Levitsky reports a lack of enthusiasm on the part of commercial banks towards taking part in these credit programmes. This reflects in part the view of these banks that loans to small enterprises are risky and involve high administrative costs, but also a reluctance to invest in training staff 'to assist small business in preparing their projects properly. Commercial banks prefer to rely more on the creditworthiness of clients and on collateral than on project appraisal.' (p. 21). To encourage the commercial banks to participate, the Bank undertook credit guarantee schemes in some countries of the type considered above.

It is clear that much of the Bank's lending was made through conventional channels and the programmes were not intended to tackle the creditworthiness/collateral problem. Levitsky (1986a) shows that the programmes did create employment, even if the costs per job created were somewhat higher than those envisaged in the Bank's plans. However, the maximum size of the small enterprises eligible for the Bank's programmes was set such that enterprises should have fixed assets of less than the equivalent of US$250,000 in 1976 prices.[10]

This resistance on the part of formal financial institutions to becoming involved in credit programmes for enterprises that are small by World Bank standards, but large in comparison with the size of most enterprises in the UIS, confirms the problems faced by small-scale borrowers when trying to obtain credit from the FFS.[11]

In summary, the FFS has not been much involved in providing financial services to the RTS and UIS and attempts to increase the involvement through special programmes, such as credit guarantee schemes, have not been universally successful. It is time now to see how institutions in the IFS have dealt with the problems listed above.

III. RELATIONS BETWEEN INFORMAL FINANCIAL INSTITUTIONS AND THE RTS AND UIS

In discussing informal financial institutions, one may identify two groups with different degrees of linkage with the FFS. The first, which might be called 'self-help saving and lending schemes', involve no direct linkage with financial institutions and rely on the mobilisation of savings within the RTS or UIS to provide the capital for loans. Important here are the so-called Rotating Savings and Credit Associations (ROSCAs). The second group involves institutions that operate independently of the commercial banks, but which may be linked to the FFS, depending on whether they are licensed or not. For example, money lenders are generally outside the FFS, but pawnbrokers may or may not be licensed. Also in this category would be included special programmes, often organised and funded by Non Governmental Organisations (NGOs), to provide financial services (especially credit) to those in the RTS and UIS.

In examining informal financial institutions across a large number of developing countries in different continents, one finds considerable variety as well as common approaches to basic problems. One interesting phenomenon that has resulted from the movement of Chinese and Indians, especially during colonial times, is the popularity of certain informal financial institutions in particular countries. Thus Ng (1985) comments on 'the conspicuous presence of professional moneylenders of Indian origin in those SEACEN countries which had been under British rule' as compared with 'the relative predominance of rotating savings and credit associations (ROSCA) and pawnshops ... in those countries where overseas Chinese represents a significant percentage of their population.' (pp. 2-3).[12] Religious and cultural differences (such as the caste structure, see Bhattacharya 1984) also play an important role in determining what kinds of financial institutions are acceptable and tolerated, in particular where the perceived needs of women are concerned.[13]

In examining alternative financial institutions, one will need to consider the way in which they deal with a number of problems: (i) how to keep down transaction costs, (ii) how to offer competitive interest rates to lenders and/or borrowers, (iii) how to keep default rates low and, in some cases, (iv) how to target particular groups of potential savers or borrowers who may have special needs, such as women.

III.1 Self-help savings and lending schemes

Since the increments in savings to be activated by many individuals are small and the periods of deposit may be relatively short, low transactions costs are very important and may outweigh the rate of interest being offered. In addition, Vogel and Burkett (1986a, b) suggest reciprocity (that is, the enhanced possibility that depositors at a financial intermediary (FI) may have of obtaining loans from that FI) may be an important in attracting small savers to particular institutions. As evidence of the importance of reciprocity, they cite the experience of postal savings deposits, which have declined dramatically in many African and Asian countries in recent years (with the exception of Singapore and Taiwan, where interest payments were tax free). While postal savings accounts offered accessibility, in the sense that

there were post offices in many areas where there were no branches of commercial banks, and were prepared to handle very small transactions, they generally did not offer credit to depositors (again with the exception of Singapore, where postal savings offices made housing loans to individuals).

This is an important point and is consistent with the formation of groups of individuals to pool their savings in order to facilitate the provision of loans, the most important being the so-called rotating savings and credit associations (ROSCAs).[14]

Rotating Savings and Credit Associations (ROSCAs). These institutions are of considerable antiquity and are found widely in Africa and Asia, but somewhat less in Latin America.[15] They are normally small groups (from ten to forty members) that agree that for a specified period the members will pay a given amount into a kitty at regular intervals. The kitty is then allocated to the members of the ROSCA in rotation until all members have received it, at which point the ROSCA either disbands or starts on a new cycle. It may be formed by a group of friends or acquaintances and carried out informally, with at most a member chosen to provide some minimum organisation. Alternatively, the initiative to form the ROSCA may come from an outside organiser or manager, who may provide the group with services in return for privileges, such as being the first borrower. The importance and popularity of ROSCAs in Korea is discussed in Cole and Park (1983).

The method of ordering the rotation is determined in various ways. In some cases where hierarchies are important, the order may depend on seniority of social standing. In other cases the ordering is determined by drawing lots, with the successful members then dropping out of future draws, but this method while appearing fair, may fail to provide sufficient incentives for the members to take part. Since no rates of interest are involved, the first borrower gains most in terms of obtaining an interest-free loan and subsequent borrowers gain decreasingly as the implicit repayment period shortens until the last borrower, who gains nothing as he will have contributed exactly the amount he receives in the final kitty. For this reason, while ROSCAs formed from groups of friends may accept the random draw method of rotation, most have developed methods of auctioning the kitty that provides incentives to members. For example, Ng (1985) reports that 86% of ROSCAs surveyed in a study in Thailand in 1970 allocated the kitty by some form of tendering.

One method of auctioning the kitty that is practised in Pakistan is described in Asian Development Bank (1990, p. 199). Suppose a ROSCA of 30 members agree to contribute $1000 each to a kitty every two weeks for 15 months. At each meeting, the kitty is allocated on the basis of an open auction with only members who have not yet received the kitty being eligible to bid, the kitty going to the member offering the biggest discount. If, at the second meeting the highest discount offered by one of the 29 bidding members is $5000, each member of the ROSCA then pays in a contribution of $862 (*i.e.* (30,000 - 5000)/29). This system provides considerable flexibility, since those who are keen to borrow early and offer large discounts are paying a relatively high rate of interest, while those who put in bids with small discounts and are content to wait until late in the cycle receive relatively high rates of interest on their contributions.

How does the ROSCA deal with the four problems listed above? First, the simple nature of the organisation and its small size tend to keep transaction costs low. Little organisation or

book-keeping is necessary and the collection of contributions and distribution of the kitty may be carried out simultaneously if members bring their contributions to a meeting and the winner departs with the kitty. Providing the member contributes regularly to the kitty and fulfils the obligations, the ROSCA is not concerned with the purpose of the loan, so project appraisal is unnecessary.[16]

Second, the question of interest rates depends on the method of rotation. If the order is culturally determined or if friends agree to rely on the fortunes of a random draw, interest rates are of little relevance. However, the majority of ROSCAs that use an auction system to determine the order of rotation provide a considerable degree of choice over the interest rate, within the constraints of the fixed time cycle of the system. One point to note is that the need to pay a rate of interest through an auction system does not keep the poor from taking part in ROSCAs.

The third problem is potential default, in this case by members who received the kitty early refusing or being unable to continue contributing to the ROSCA for the rest of the cycle. Since the provision of collateral is not one of the solutions, safeguards against this happening vary . For example, if the rotation is determined by social or cultural constraints, these may well be sufficiently strong to ensure compliance. If friends or homogeneous groups, such as neighbours or fellow workers, are involved, the risk of default may be very low, since would-be members who judged to be potential problems may be refused entry. If the groups are not homogeneous, the rules of entry may be strict enough to ensure that members about whom there are doubts are only eligible to borrow late in the cycle. In any event, all accounts of the operations of ROSCAs suggest that the default rate is not a problem.

Finally, the basic simplicity of the system and the considerable flexibility in terms of the size of the group, the size of contributions, the length of the cycle and the method of rotation suggest that ROSCAs should be capable of allowing particular groups to target themselves. Those likely to be excluded from the possibility of forming or being invited to join ROSCAs are those who do not have access to the funds to make the required regular contributions and/or those who are isolated from contact with potential ROSCA members. In many societies, women are likely to be disqualified on both counts and descriptions of ROSCAs suggest that they are predominantly male organisations.

III.2 Informal lending institutions

The institutions to be considered here may be grouped under three headings. First, following on from the discussion of ROSCAs, are other examples of institutions that attempt to link savings to the provision of credit, in particular the credit unions that have developed particularly in Latin America and then the thrift and credit schemes that have been encouraged in a number of African countries. Second, there are the traditional sources of credit, of which moneylenders and pawnshops are the most important examples. Finally, we shall examine a number of institutional arrangements established through special credit programmes, often sponsored and funded by international organisations and (NGOs).

Credit unions. These were discussed briefly above as being larger and more formal versions of the basic idea of the ROSCA and they illustrate some of the effects of extending the scale

of the operations. On the positive side is the ability of the institution to link savings to the provision of credit very closely. Vogel and Burkett (1986b) report studies from Latin America that suggest that transactions costs in credit unions were lower than in commercial banks, but while costs did not rise too rapidly with increased scale, there were problems of members' control over those running the unions (*e.g.*, members of the board were often found to receive a disproportionate share of credit union funds). Default rates, while generally not a problem, were sometimes considerably higher than for the ROSCAs.

Vogel and Burkett argue that a major difficulty faced by credit unions in Latin America, as well as in parts of Africa, is that the link between savings and credit was often undermined by governments or NGOs who have seen credit unions as instruments for achieving objectives, such as increasing agricultural output or improving incomes of the rural poor. These additional objectives have imposed constraints, so that credits have been tied to schemes that were not the choice of the borrowers and the channelling of funds from international donors through credit union federations to encourage such schemes has tended to undermine the incentives for mobilising savings. They conclude that:

The main problem with credit unions in providing opportunities for small savers is not that they are inappropriate forms of organisation, but rather that they have been diverted to other purposes that are inconsistent with focusing on providing good service for depositors. (p. 26.)

Cooperative Thrift and Credit Societies. A number of examples are quoted in Mayoux (1988) of institutions that arrange for the collection of savings and the granting of loans at low rates of interest. These may involve larger groups than found in ROSCAs (Moepi 1988 reports that 31 such groups in Botswana had a membership of 3,650) and the membership rules may be much more formal (Jallow 1988 describes Cooperative Thrift and Credit Societies (CTCS) in the Gambia in which members have to pay an entrance fee of D2.50 (about US$1.00 in the early 1980s), purchase a share of D10.00 and save for six months, earning interest at 8% per annum before becoming eligible to borrow at an interest rate of 12% per annum). The success of these institutions is difficult to evaluate, since the reports do not discuss transactions costs and there is little discussion of recovery rates (with the exception of Kamara 1988, who reports problems of favouritism and poor repayment rates by those members favoured in Sierra Leone).

Moneylending. Turning to sources of credit that do not involve a savings commitment, money lenders have been the traditional source of credit in many poor communities, particularly in rural areas. Judgements concerning their operations vary and while some have seen them as usurers whose monopolistic position allows them to exploit their poor victims, a number of studies that have examined the evidence for this stereotyping of the money lender as the usurer have concluded that this picture may be misleading. For example, the Asian Development Bank (1990) reports on a study of 14 villages in Thailand that showed that 11 of the villages had at least four moneylenders and that outside moneylenders were also active, which suggests that the view of the monopolistic position of the money lender may be exaggerated in some cases. This is a result one would expect if there is an opportunity to compete for monopoly profits and freedom of entry is not blocked.

However, the freedom of entry is conditioned by the need to obtain the information necessary to assess the creditworthiness of the borrowers, which is essential in the absence of collateral.

In many cases this is obtained by the proximity of the lenders to the borrowers, which may give the local money lender an advantage to earn a rent on his specialised knowledge, but tends to keep transaction cost low.[17] However, the fact that money lenders from outside the villages can compete, suggests that this monopoly may not be very strong in some cases. In examining the interest rates charged by money lenders, Ng (1985) presents data for Malaysia that suggests that when the risk premium is taken into account along with the opportunity cost of using the funds for this purpose, any element in money lenders charges attributable to monopoly is a relatively small proportion of the interest rate. Many rural borrowers need loans to smooth consumption over the year when incomes are seasonally peaked at harvest time and surveys suggest they do not see the food provided on credit from the money lender during the non-harvest period as being exploitation. As Johnny (1985) points out regarding Sierra Leone, the need to obtain credit annually provides a strong incentive for borrowers to repay their debts in order to ensure the provision of loans in future years.[18]

Having looked at empirical evidence for a number of developing countries, Holst (1985) concludes that:

> *The conventional views of the performance of the informal financial sector need to be reversed in the light of the empirical evidence. The performance of informal institutions is definitely commendable in the following respects:*
>
> *(a) Moneylenders, indigenous bankers and savings and credit associations respond remarkably well to their customers' short-term financing needs and cover also rural areas where the density of formal institutions is still low. Borrowers appreciate in particular their flexible procedures and the locational conveniences;*
>
> *(b) The efficiency of these institutions in terms of transaction costs (costs related to the default risk and administrative costs) appears to be quite favourable. In many cases, costs tend to be lower than that of formal institutions, in particular, in dealing with small farmers and small businesses;* (p. 141).

In summary, the usual close proximity of money lenders to the borrowers can reduce the transaction costs and use of the resulting knowledge obtained by this proximity can provide an assessment of risk that enables them to charge a risk premium and reduce the need for collateral. However, in the absence of collateral, the risk premium tends to be higher than that charged by other lenders, which makes the interest rates charged by money lenders higher than those charged by institutions in the FFS, though such comparisons may be very misleading, since the borrower is not the same in both cases in terms of creditworthiness or availability of collateral and transaction costs are not taken into account.[19] There is some evidence of competition and, while this may not be sufficient to remove the element of monopoly profit, it suggests that the view of the money lender as an exploiter of the poor and helpless needs to be investigated carefully before judgement is passed.

Pawnshops. While the pawnbroker has become relatively less important as a source of credit in most developed countries, the pawnshop still has a role to play in many developing countries. Since money is only advanced against collateral, there is no need for the lender

to devote resources to assessing the creditworthiness of borrowers, though some expertise is required to assess the value of the item pledged, which may typically be jewels, ornaments, gold, silver and other items of value such as various consumer durables.[20] The expertise necessary to assess the pledges may have been acquired independently of the activity of pawnbroking, since jewellers or gold dealers often operate as pawnbrokers, so that the cost of this expertise does not have to be covered by profits from pawnbroking. Given such expertise, the time involved in arranging the loan is minimal and this tends to reduce transaction costs. This means that a person wishing to pawn some item can expect not to find long queues and can transact business discretely with the pawnbroker. However, pawnbrokers have a bad reputation generally, because they are said to charge exorbitant interest rates and to make considerable profits by selling the goods that are not redeemed (see Bhaduri 1989, p. 245).

Bouman and Houtman (1988) present data for Sri Lanka, where pawnbrokers are officially licensed, though there are unlicensed pawnshops operating illegally. They found that a legal pawnbroker made a return on capital of about 10%, which was not particularly usurious, but that an unregistered pawnshop was making a return of 70% on capital. They concluded that in part this high return reflected the extra risk incurred through the illegality of the unregistered operation and racial problems; many of the unlicensed pawnshops in Colombo belonged to Tamils and some were destroyed in riots in 1984. They question the validity of the argument that pawnbrokers make their profit from unreclaimed pledges and suggest that it is more profitable for the lender to provide credit repeatedly to the same customer using the same pledge.

Sri Lanka is an interesting case because rural banks saw the possibilities and offered pawning facilities. While this business expanded rapidly at first, it was unable to dominate the private pawnbrokers for a number of reasons. First, the price offered by the banks for gold did not adjust as rapidly in response to inflation as did the pawnshops. Secondly, the rural banks put conditions on the purposes of loans, that they be for essential or productive purposes, whereas pawnshops did not interfere with their customers' affairs. Thirdly, the rural banks operated at hours that were less flexible than the pawnshops and took time to process applications (see Chandavarkar 1989). As a result, their business was proportionately much less than that of the pawnshops.

They suggest a number of reasons for the popularity of pawnshops as a source of credit. One advantage is that while the borrower loses the pledge if the loan is not repaid in full, that is the end of the matter and the borrower incurs no liability to pay further interest on the loan. This avoids the potential dangers of an ever-increasing debt load. Transactions costs are low and access to funds is very rapid compared with the processing of loan applications in the FFS. As in the case of other forms of informal financial credit, it seems that rates of interest higher than those operating in the FFS, from which the borrower may anyway be excluded, are not the major consideration.

If it is the case that most customers who use pawnshops redeem the pledge, then in principle this form of collateral should be acceptable to the FFS, though the small value of many transactions and the need for the expertise to assess the pledges might make the costs too high for this to be economical. Given the generally negative view of pawnbroking in many

developed countries, it is unlikely that commercial banks in developing countries would be enthusiastic to detract from their 'Westernised' images by undertaking this kind of business.

Credit programmes run by international organisations and NGOs. In addition to the traditional sources of credit available through the IFS, innovations have come from both indigenous and external NGOs, as well as international organisations such as USAID and the World Bank aimed at providing financial help to some of those working in the rural and UISs.

Harper and de Jong (eds, 1986) report the work of a number of NGOs in financing small enterprises, while IFAD (1985) details the effort of the International Fund for Agricultural Development (IFAD) to provide credit to the rural poor. Both studies report many problems with the default on loan repayments and highlight the difficulties and costs of the supervision of loans when the amounts are relatively small and there is little or no collateral provided by the borrowers. Given the NGO's lack the local knowledge of those involved in many informal financial institutions, the costs of assessing creditworthiness add considerably to transactions costs.

Further problems may be caused by programmes that attempt to provide cheap credit by offering loans at low rates of interest. The philosophy underlying some of these programmes seems to be based on the assumptions that because the poor live close to the margin of subsistence, they can neither save nor afford to borrow at 'high' (*i.e.* commercial) rates of interest. While well intentioned as methods of undercutting what are seen as the exploitatively high rates of interest charged by money lenders, the effects of subsidised credit programmes have not always been successful. As was suggested above, the high rates of interest charged by money lenders contain a risk premium and in the absence of the information possessed by these lenders, the credit programmes often suffer from serious problems of default. In addition, the low rates of interest have the effect of discouraging the accumulation of local savings, which deprives the poor of potential channels of saving that could increase the amount of funds available for credit to be loaned at a realistic rate of return to the saver. On balance, in the case of rural credit programmes, the evidence seems strongly against the provision of cheap credit as opposed to encouraging savings through price incentives (see Adams, Graham and Von Pischke 1984 and Remenyi 1991).

The work of the World Bank in lending to small-scale enterprises was discussed in the previous section in the context of its attempts to encourage the commercial banks to participate. In contrast to the approach of the World Bank, the Grameen Bank set out to develop a system that would deliver credit to the rural poor, especially women, in Bangladesh independently of the FFS.

The Grameen Bank. The foundation of the Grameen Bank goes back to work by Professor Muhammad Yunus of the University of Chittagong in a small-scale project in the village of Jobra (Chittagong) in August 1976. The first few years saw some experimentation with the way in which loans were made, but by 1979 the basic structure of what has become known as the Grameen Bank system had evolved. It received sponsorship from the Bangladesh Bank and some commercial banks in 1979 and the experiment was extended to include the whole province of Tangail (see Siddiqui 1984 and Yunus 1989). In September 1983 it was transformed into an independent bank with the name GRAMEEN BANK. The government

of Bangladesh provided 60% of the initial paid-up share capital of the bank, while 40% was held by borrowers of the bank. In July 1986 the share capital was increased, but with the government's proportion reduced to 25% and 75% being subscribed by borrowers of the bank.

The Grameen Bank was seen to be successful as it demonstrated not only that it was possible to provide savings opportunities for and operate credit programmes with very poor women in rural areas, but that it was also possible to obtain extremely high rates of punctual repayment of the loans. This success attracted the attention of international agencies and it received loans from the International Fund for Agricultural Development (IFAD) of US$3.4 million in 1981, and US$37 million in 1985. The arrangements were that IFAD lent to Bangladesh Government for 50 years at 1%, the Government lent to the Grameen Bank for 20 years at 2%, while the Bank charged 16% on the loans it made (Yunus 1988, pp. 9-10). By end of 1988 the Bank obtained a new loan of US$125 million from IFAD and charitable organisations, such as the Norwegian agency NORAD, the Swedish SIDA and the Canadian CIDA.

From 25 branches with under 15,000 members in 1980, the Bank had grown to over 630 branches with about 630.000 members in 1989 and, according to Yunus (1988), plans to have 1700 branches operating by 1995. The total disbursement of Tk 21 million in 1980 (when US$1 = Tk 15.48) grew to nearly Tk 550 million in 1986 (when US$1 = Tk 29.89) and was expected to be about Tk 1500 million in 1989.

Yunus has been an impassioned and articulate proselytiser for the institution and the Grameen Bank has published a stream of books and papers outlining in harrowing detail the poverty of its clients and the improvements in their lives that have resulted from taking its loans (see, for example, Ray 1987 and Yunus (ed) 1987). These publications contrast strongly with the more sober reports and advertising from the commercial banks in developing countries, with their emphasis on middle-class customers and services. From the outset the Grameen Bank had a wider aim than merely providing a credit programme. For example, it set out to help women, who were particularly constrained in rural muslim communities, to teach discipline and inculcate habits of saving and financial planning, if only on a small scale.

The Grameen Bank has attracted considerable attention, since on the one hand it seems to be extremely successful in making loans without collateral and achieving repayment rates of 98-99% and, on the other, many economists are puzzled as to why it works. To explain its success, its operating procedures will be described in sufficient detail to show how it deals with the problem of assessing creditworthiness in the absence of collateral.

In its operations in Bangladesh, the Grameen Bank works with a basic unit of a group of five people, with six such groups being formed into a centre consisting of thirty members. In addition to weekly loan repayments, members are required to pay a small Group Tax and make small weekly personal savings into a Group Fund. Members are able to borrow from the Group Fund for consumption and investment purposes, with the agreement of the remaining members (Ghai 1984).[21]

When the Grameen Bank system has been exported to other developing countries, most of the basic characteristics outlined above have been transplanted. Thus Hulme (1990) in summarising schemes in Malaysia, Malawi and Sri Lanka reports that all of them operated

(i) with groups of five members;

(ii) of the same sex;

(iii) formed into centres of thirty;

(iv) that membership was restricted to the poor;

(v) that loans to women were favoured;

(vi) that repayments were made at the weekly group meetings;

(vii) that groups were penalised for individual non-repayment;

(viii) that all transactions were conducted openly at centre meetings;

(ix) that members had to contribute savings and to the Group Tax; and

(x) that the offices of group and centre leaders rotated annually.

While all of these characteristics may be desirable and important from some points of view, by considering the basic problem the Grameen Bank set out to overcome, it is possible to argue that some are more important than others. When looked at from the lender's viewpoint, a poor borrower represents a high risk, since he or she has neither a known credit rating nor collateral. This deters most conventional credit schemes from lending to such customers.

The crucial factor in the success of the Grameen Bank is that it provides a system for shifting most of the risk of default from the Bank to the borrowers. The borrowers respond by using local knowledge and group-pressure to ensure risk is minimised. When potential borrowers approach the Bank and are told they must form themselves into groups of five, they know that the 'rules of the game' are that they will be penalised if members of their group default. Since they are going to form the group from among their friends and neighbours, they have access to a great deal of local knowledge that is denied to the Bank and can use it to weed out potential bad debts at the outset. The fact that the group is penalised for individual defaults acts both negatively to provide group pressure on the potential sinner and positively to provide group support for individuals who get into genuine difficulties. The utilisation of local knowledge and the effects of group pressure play a central role in the achievement of the very high repayment rates reported by the Grameen Bank.

Once enrolled in the credit programme, the members can prove their honesty by maintaining their weekly repayments and, upon the punctual termination of the loan, they normally become eligible for further loans. The fact that within many Grameen Bank schemes the loans get larger at each stage tends to reduce the risk of a group decision to default on a loan and this is reinforced by the fact that the groups are drawn from the same village and would be liable to pressures from their more honest peers within the Bank. It might seem that the time of greatest risk for group default would be the point at which a group reaches the end of the credit cycle, but those in groups that are at earlier stages in the cycle are aware that such defaults would reduce the funds available for their future loans and hence the probability

that they would complete the cycle successfully. There is thus a strong incentive for social pressures to be applied to ensure that such defaults do not occur.

Focusing on the economic rationale underlying the Grameen Bank system would suggest classifying the ten basic characteristics into the following groupings:

1. **Aims of Bank**: (iv) and (v), with the position of women in many rural communities requiring (ii).

2. **Essential**: (i), (vi), (vii) and (viii), since these characteristics provide the basis for peer-group pressure.[22]

3. **Non-essential but probably useful**: (iii), (ix) and (x).

If the interpretation of the Grameen Bank system proposed here as a way of tapping local knowledge and transferring risk from the bank to the borrowers is correct, it would suggest that the system should not be specific to Bangladesh or even to the particular characteristics of rural communities. Hulme (1990) provides examples of the replication of the Grameen Bank in rural areas of Malaysia, Malawi and Sri Lanka and Thomas (1990a, b) discusses the transfer of the Grameen Bank approach to the UIS in Lima.[23] Yunus (1988) reports (without providing financial details) on a number of initiatives in the United States, such as the work of the South Shore Bank in Chicago, the Winrock Foundation in Arkansas that was establishing a bank to lend without collateral to welfare recipients, and the Cherokee Nation in Oklahoma.

Having provided an ingenious method of solving the collateral problem and keeping default rates low and shown its ability to target specific groups, how does the Grameen Bank perform with respect to the two other problems of providing credit to the poor? The evidence on transactions costs is difficult to interpret as lending is often combined with the provision of other non-credit services, such as the distribution of seeds and hire of tools in rural areas or very basic training in book-keeping and stock control in the urban applications of the system. Without access to detailed financial accounts, it is difficult to allocate costs between the different activities, but the general picture is that overall costs are low, since the Grameen Bank system does not need expensive office facilities and the staff tend to be dedicated workers, so that the salary bill is also relatively low. As far as rates of interest are concerned, borrowers are charged the going commercial rate, so that this is not a subsidised credit programme. The fact that poor borrowers can pay this rate of interest and still achieve such high repayment rates confirms the fact that access to credit is more of a problem for the poor than the particular level of interest rates.

The system works because the risk is shifted from the lender to the borrowers, who make use of their local knowledge of who is credit worthy to reduce the risk of default. However, risk aversion is a double edged weapon: it may work well when potential group members are being assessed by barring those who are likely to be bad risks when it comes to repayments, but when combined with low income levels, it is also likely to reduce the range of investment opportunities considered by borrowers.[24]

One question concerning the success of the Grameen Bank programme is whether it can be adapted to provide loans to the less poor or to encourage more adventurous use of loans without losing the advantages of the system? The policy of giving small loans to the poor and working with small, homogeneous groups is more amenable to the use of peer-group pressure than providing loans to those who are better off and who tend to be able to approach sources of credit individually.

Devereux and Pares (1987) quote Avandhani's analysis of repayment data for India, from which he concluded that 'A larger proportion of farmers repaid loans among marginal, small and medium farmers than among large farmers, both in 1961-62 and 1971-72 ... . This would imply that repayment performance of the large cultivators was generally bad in both periods ... richer farmers had defaulted more than smaller cultivators in their repayment performance.' (p. 31). They also quote one of Oxfam's Assistant Country Representatives who ascribed many of the difficulties met in two Oxfam planting schemes in Orissa to the fact that the schemes were directed at large, non-homogeneous groups so that 'Since the programmes' structure was community based rather than based on a particular social or economic class (where there are more likely to be feelings of common identity and solidarity), this mixed membership neutralised any social pressure that a group as a whole could otherwise place on defaulters.' (p. 44).[25]

In summary, with the exception of the pawnshop, which solves the problem of assessing creditworthiness by obtaining physical collateral, other sources of credit, such as moneylenders and indigenous banks, make use of their detailed local knowledge to assess risk. The Grameen Bank has found another way to tap into local knowledge without needing to transfer this information to the Bank and has generally produced impressive repayment rates. Most informal sources of credit charge interest rates that are higher than those that would apply in the hypothetical situation in which their borrowers could obtain loans from formal financial institutions. The message that emerges from many studies is that the level of interest is often of less importance than high transaction costs, complex application procedures or long delays in processing applications. Some of the formal financial institutions involved in World Bank credit programmes have been criticised on these latter counts. These are clearly some of the problems to be addressed if credit is to be forthcoming from the FFS. It is also clear that the poor can save and that providing channels for savings is important, both to enable the poor to obtain a reasonable rate of return on their savings and to mobilise savings as a source of credit.

IV. THE INFORMAL FINANCIAL SECTOR AND MONETARY POLICY

To evaluate the relevance of 'financial dualism' and 'financial repression' for monetary policy in developing countries, it is necessary to estimate the size of the IFS. This has proved to be a difficult problem, since the unregulated nature of the IFS means that statistical data are not routinely recorded by governmental or private agencies.[26] Two recent surveys (Asian Development Bank (1990) and Germidis, Kessler and Meghir (1991)) contain estimates of the size of the IFS for various developing countries and Table 1 below presents a consolidation of the results from both these sources (which should be consulted for bibliographical details of the individual studies).

Quantitative data may relate to different dimensions of the IFS, such as (i) the proportion of the population which participates in the IFS, (ii) the volume of transactions in the IFS and (iii) the value of transactions in the IFS. Much of the information that is available has been collected through sample surveys and this method of data collection has produced mainly estimates of (i) and (ii) rather than (iii), since it is generally easier to obtain accurate data on the number of households participating and the proportion of loans involving the IFS than it is to collect data on the value of the loans in question. Much of the data presented in Table 1 relates to (i) and (ii). Clearly these data are relevant to the discussion in previous Sections, since the relatively high percentages of households involved and high proportion of total credit obtained from informal sources confirm the extent to which the RTS and UIS are reliant on the IFS for credit. However, they do not provide much information about the size of the IFS in relation to the FFS.

Little or no information exists on the value of IFS transactions for most developing countries, making it difficult to evaluate the impact of the IFS on monetary policy. However, despite the large percentage of the population participating in the IFS, the generally small scale of credit transactions involved suggests that, in aggregate terms, the total value of IFS transactions is relatively small in comparison to the FFS. This conclusion is speculative, but the absence of data makes it difficult to provide statistical evidence.

The other problem in evaluating the importance of the IFS is the absence of data on the IFS for most countries over time, so that it is difficult to judge whether the IFS has been increasing or decreasing in importance in recent years. It would clearly be desirable to obtain such data, which would provide some insight into the cyclical behaviour of the IFS.

Despite the considerable theoretical discussion of 'financial repression', the empirical importance of the IFS from the point of view of monetary policy is difficult to determine. However, it is possible to shed some statistical light on a related question: what effect does monetary policy have on the IFS and its customers? The discussion in the previous Section has shown that some institutions in the IFS, such as ROSCAs, are widely used by clients in the modern sector as well as those in the RTS and UIS. The evidence suggests, however, that for such clients, these IFS transactions are small relative to their involvement in the FFS, so that the main impact of monetary policy is likely to come through its effects on the FFS rather than the IFS.[27]

Table 1: Some indications of the size of the informal financial sector

Country	*Credit source*	*UIS*
Bangladesh	33-67% of rural borrowing from informal sources.[1] 63% of credit from informal sources.[2]	--- ---
China	33-67% of all borrowings from informal sources, mid-1980s.[1]	---
India	38% of rural household debt owed to IFS, 1982.[1] 1961: 83%, 1971: 71%, 1981: 39% of rural household debt from IFS.[2]	40% of urban household debt owed to IFS, 1982.[1] 30% of urban credit from IFS.[2]
Indonesia	83% of agricultural households received no formal credit.[2]	93% of capital of UIS households with business activities came from own funds and 'other sources'.[2]
Korea	51% of average liabilities of farm households from IFS.[1] 50% of average outstanding loans of farm households from IFS.[2]	--- Urban informal credit was 15% of deposit money bank loans, 1978.[2]
Malaysia	70% of rural borrowing from IFS.[1] 62% of all farm loans from IFS.[2]	--- ---
Mexico	50-55% of farm credit from IFS.[2]	---
Nepal	76% of farm family credit from IFS.[1]	---
Nigeria	95% of farm loans from IFS.[2]	---
Pakistan	69% of rural credit from IFS.[1]	---
Philippines	70% of rural credit from IFS in 1987.[1] 1950s and 60s: 60% and late 70s: 78% of rural credit from IFS.[2]	45% of urban credit from IFS in 1987.[1] Less than 10% of small and medium businesses received formal credit.[2]

(continued / ...)

Table 1 *(continued)*: **Some indications of the size of the informal financial sector**

Country	*Credit source*	*UIS*
Sri Lanka	45% of credit to paddy farmers in 1975-76 from IFS.[1]	---
Thailand	45% of outstanding credit from IFS in 1987.[1] 52% of rural credit from IFS.[2]	--- 17% of total deposits and 20% of total loans with IFS.[2]
Zambia	43% of farm credit from IFS.[2]	---
Zimbabwe	87% of farm credit from IFS.[2]	---

Sources: 1. *Asian Development Outlook*, 1990, p.189, Table 3.1.
2. Germidis, Kessler and Meghir (1991), pp.44-5, Table 1.3.

(See these sources for bibliographical details of the studies summarised in Table 1).

The impact of monetary policy is likely to be very different on clients of the IFS in the RTS and UIS, since as the statistical evidence presented above suggests, they are generally excluded from the FFS and must therefore respond to policy changes within the constraints of the IFS. Since the institutions in the IFS mainly provide credit and only offer limited channels for savings, clients of the IFS are denied most of the opportunities available in the FFS for portfolio diversification, such as international transactions (including capital flight).

The importance of this difference may be illustrated by considering a change in monetary policy that leads to an increase in prices and examining the relative impact of the resulting 'inflation tax'.[28] Evidence from various developing countries suggests that because the poor hold relatively large proportions of their assets in the form of cash, they are subject to high rates of 'inflation tax'. Gil Díaz (1987) presents data for Mexico, dividing government debt into non-interest earning debt (bank notes and coins plus any non-interest deposits) and interest earning debt. For the former group of assets, the inflation tax is the rate of inflation, which was 29.8% in 1980. For the latter group of assets, the inflation tax is less than this by the rate of interest the government pays on these assets, which in 1980 reduced the inflation tax to 12.7%. He also presents data which show that families were more likely than firms to be affected by the inflation tax because they held 91% of non-demand deposits and 60% of currency. Among families, those in the lowest income decile held the highest percentage of currency (relative to income by decile), so that the poor would be particularly susceptible to the effects of an inflation tax.[29]

Studies examining the welfare effects of monetary policy are rare in the financial analysis of developing countries, but given the high percentage of poor people in the populations of these countries, these effects should not be ignored. Hence, it is important that the effects of monetary policy on the IFS and its customers should be considered as well as the effects of 'financial dualism' on monetary policy.

V. CONCLUSIONS

In the analysis of monetary policy in developing countries, the IFS is mainly discussed in the context of 'financial repression'. Statistical information on the size of the IFS is scarce, but the evidence presented above suggests that despite the large number of agents involved in the IFS, the small average size of transactions in the IFS may mean that it is small in comparison to the FFS. However, the 'financial dualism' approach imposes a 'double dualism' on the analysis and ignores UIS, a sector of considerable size and importance in many developing countries.

This *Working Paper* has concentrated on the problems faced by workers in the RTS and UIS in obtaining access to credit. While rural credit has been widely discussed in the past, this has been less true of the needs of those in the UIS. In turning to the implications of credit provision for monetary policy, it is noticeable that in contrast to the prominence of the UIS in studies of employment and poverty in developing countries, when monetary policy is being discussed, even where there is reference to the problems of the rural sector, the UIS is hardly if ever mentioned. For example, even the country studies in this study which discuss banks and credit programmes in rural areas do not discuss the UIS, and the same is true of such a widely used textbook on monetary policy in developing countries as Fry (1988).

Why is this? One may suggest a number of reasons. First, the concept of the UIS has had a relatively late and limited impact on the well-established dichotomy between the rural sector and the urban (*i.e.* formal) sector that characterised the early dualist models of development economists. Even when the UIS was recognised as an element in the adjustment of the urban labour market, is was seen as one of the job-search options open to the rural migrant in search of a formal sector job (see Fields 1975) and since it was merely a staging post on this route, it was generally ignored in macroeconomic modelling and policy discussions.

The second reason is the attitude of politicians and policy makers to the UIS, which has varied from being strongly negative to ambivalence and, at best, neglect. In the 1960s, during the industrialisation and export-orientated phase of development, the UIS with its primitive technology and reliance on traditional techniques was seen as an anachronism. The activities of street sellers in the modern business and tourist areas together with the growth of slums and squatter settlements on the fringes of affluent areas were seen as blots on the modernity of the country and the middle-class assumption, based on observation from a safe distance, that the UIS was full of petty criminals, produced a generally hostile attitude. With the growing realisation that even under the most favourable economic conditions, the modern sector could not expand fast enough to absorb the rapidly increasing urban labour force and that neither public nor private housing programmes could provide enough places for them to live, governments tended to become more tolerant of the UIS and informal (or spontaneous) housing. The result was a policy of benign neglect, in which there was less overt hostility towards the UIS, which was generally left to its own devices. Finally, with the world recession and the effect of the debt crisis, many developing countries have seen employment in the formal sector falling and some governments have begun to see a more positive role for the UIS, with its ability to create jobs for the poor and the unskilled.[30] This final phase has led to some policy changes and increasing interest in supporting the UIS.

The third factor may be that although the UIS is important for employment, productivity is low and it generates so little income that it has a small effect on monetary policy. For example, Carbonetto and Carazo (1986) estimate that in Peru in 1981 the UIS only generated the equivalent of 7% of Gross Domestic Product, while the formal sector generated 78.7%. This suggests that even relatively large changes within the UIS are unlikely to affect the parameters of monetary policy. Whether this is the case is an open question and seems not to have been the subject of much research, which reflects the lack of interest in the UIS on the part of most model builders. It is possible, however, that the ability of the UIS to absorb labour and the evidence for counter-cyclical movements demonstrated above for some countries could reduce the effectiveness of policies intended to operate on the labour market by increasing unemployment.[31]

Finally, monetary policy is mainly concerned with the FFS and the role of the commercial banks. The commercial banks are linked to the formal sector through their dealings with private sector customers, the public sector, government and, to some extent, to the rural sector, though generally only to large-scale agricultural production. The one sector with which they have little or no contact, for reasons that were discussed above, is the UIS.

While these reasons may explain why analysts of monetary policy have not considered the UIS, the case still has to made as to why they should. The main reason is that the UIS provides employment for a large proportion of the urban working population and it has played an increasingly important role in expanding employment during the world recession. Evidence suggests that while employment in the formal sector has declined in many developing countries, employment in the UIS has moved counter-cyclically.[32]

In summary, the UIS represents an important component of non-agricultural employment in most of the developing countries in Africa, Asia and Latin America. If anything, the effect of the world recession and the international debt crisis has been to increase its importance and evidence from a number of countries suggests it may have moved counter-cyclically and helped to soften the effects of recession somewhat. Given economic forecasts have not been optimistic concerning the prospects of rapid growth in the developed countries and a resulting increase in the demand for exports from developing countries, the UIS may have a considerable positive short-term role to play in the adjustment to recession.

Studies of the UIS have emphasised lack of access to credit as the major problem faced by those working in that sector, but until recently the problem has been largely neglected in discussions of monetary policy in developing countries. Despite this neglect on the part of many policy makers and formal financial institutions, some small borrowers have obtained loans through a variety of informal financial institutions, examples of which have been discussed above. These institutions have dealt with the basic problems that such borrowers usually lack creditworthiness and do not possess collateral in a number of ways, usually through the mobilisation of local knowledge or local group pressure and support. Dealing with these problems has its costs and this is reflected in interest rates and other charges that are higher to borrowers using informal financial institutions than they would be in the FFS, if this were open to such borrowers.

The general view from outside the IFS is often based on prejudice rather than empirical analysis, but such evidence suggests that the view that moneylenders are able to operate

monopolistically may not reflect a true picture. Similarly, the view that people in the RTS or UIS cannot save tends not to be accurate and many schemes to mobilise savings from such people are often very successful (see Padmanabhan 1988 and Leibel 1989). While risk evaluation is as important in the informal as the FFS, often commercial banks impose inappropriate standards (for example, in granting loans only for investment and not for consumption) on applications from the informal or rural sectors. All of these factors reduce the access of small borrowers to the FFS.[33]

Some attempts have been made to involve the commercial banks in providing small loans, for example through credit guarantee schemes, but these have not been very successful in developing countries. One approach that is worth further exploration is the possibility of linking the IFS to its formal counterpart. Some encouraging small beginnings have been made in a number of countries, but a great deal of further work will need to be done to persuade commercial banks to participate.[34]

As this *Working Paper* has shown, there has been a considerable amount of research on the characteristics of small borrowers and the different credit institutions in the IFS that provide the bulk of what credit they get and the limited channels for mobilising their savings. It may now be time for the emphasis in future studies to focus on the examination of potential linkages between small borrowers and the FFS. Whether these will involve the FFS acting through existing UIS institutions or the creation of new intermediaries remains to be seen. However, it is important that in analysing the possibilities, arguments for market efficiency are not overemphasised at the expense of welfare considerations relating to the current customers of the IFS who are in the RTS and UIS.

NOTES

1. Despite its popularity in the literature of development economics, there are different approaches to the definition of the urban informal sector (UIS). Economists associated with the World Bank have concentrated on differences in the economic characteristics of the informal and formal sectors, such as freedom of entry in the urban informal sector and barriers to entry in the formal sector, *etc.*, (see Mazumdar 1983 and Fields 1990). The ILO has taken a more pragmatic approach and defined the UIS in terms size characteristics, such as employers and workers in enterprises below a certain size (which varies across countries depending on institutional arrangements), the non-professional self-employed, family workers (both waged and unwaged) and homeworkers (see Sethuraman 1981). While many economists would accept the first view for purposes of theoretical modelling and the second view for empirical analysis, other social scientists have taken a more political view and have discussed the UIS in terms of 'petty commodity production' in the context of the international capitalist system (see Moser 1978, 1984).

2. Evidence of the importance of the UIS in providing employment is available from many studies carried out by the ILO. For Africa, Charmes (1990, p. 20, Table 3) provides data from the mid-1970s on the share of UIS employment as a percentage of the non-agricultural labour force for Côte d'Ivoire (48%), Egypt (59%) and Tunisia (38%) and, in 1982, Morocco (57%). For Asia, Sethuraman (1988) estimates that 'The urban informal sector seems to account for between a third and two thirds of total urban (non-agricultural) employment depending on the definition of the sector: Pakistan (several cities, 1972-73), 66 per cent; Bangladesh (Dhaka) 67 per cent; India (several cities), 45-63 per cent; Thailand (Bangkok) 40 per cent; Indonesia (all urban) 53 per cent; Philippines (urban and rural), 62 per cent.' (p. 2).

Data for a number of Latin American countries suggests that as a percentage of the non-agricultural labour force, the UIS grew between 1980 and 1985, with the biggest increases being in Brazil (from 24.1% to 30.1%) and Mexico (from 24.2% to 29.5%), with the overall growth for Latin America being from 26.1% in 1980 to 30.7% in 1985. The relative importance of the UIS may be seen by noting its size relative to the private formal sector and that the private formal sector (as a percentage of the non-agricultural labour force declined in this period, in Brazil from 65.0% to 58.2%, in Mexico from 54.0% to 44.4% and overall in Latin America from 58.1% to 52.5% (ILO 1988, pp. 58-9, Table A.8).

This change in the composition of the non-agricultural labour force is also illustrated in Charmes (1990, p. 24, Table 5), where for the period 1980-85 rates of growth in informal employment were higher than in private formal employment. In Brazil informal employment grew by 9.3% and private formal employment grew by 2.2%, while for Mexico the growth rates were 8.4% and -0.7% respectively. The most extreme case was Peru, in which the growth rates were 6.5% and -3.4%, while overall for Latin America the figures were 6.8% and 1.2% respectively.

3. As we shall see below, it is difficult to draw a sharp line between formal and informal financial institutions and provide a definition that will hold for particular institutions in all

countries, but in the FFS one would include institutions that are registered, licensed and recorded, *i.e.* the central bank, the commercial banks and other banks, such as agricultural or industrial banks, that are subject to financial controls and operate to make profits on their activities. In the IFS one would include institutions that are unregulated, unlicensed and/or unrecorded, such as moneylenders, pawnshops, savings co-operatives, credit programmes organised by governments or NGOs, *etc.* This is a convenient classification, since in general moneylenders, pawnshops and savings co-operatives are not licensed (and hence are informal), while many of the credit programmes are not directly concerned with profitability and hence differ from the commercial banks and other institutions in the FFS. While informality may involve illegality, this is not a necessary characteristic of informal financial institutions.

4. In discussing the financial needs of the UIS, the reader should bear in mind the heterogeneity of the sector, which is brought out by the descriptive definition provided in footnote 1 above. Since those working in the UIS range from employers in small enterprises to unpaid family workers, their financial needs will vary, but the lack of access to the FFS generally affects them all. It should be stressed that the concentration on the UIS reflects its relative neglect in discussions of financial institutions and monetary policy. Many of the same issues arise in connection with problems of rural savings and credit, but these have already been widely discussed. See, for example, Von Pischke, Adams and Donald (eds) (1983). Relevant evidence relating to rural credit problems and programmes will be presented in Section III.

5. This can be a problem for would-be borrowers in rural areas. As Johnny (1985) notes for Sierra Leone, 'Farmers cannot use their most tangible property - land - as credit collateral because of the customary communal system of land tenure which prevails in the provinces (which does not provide individual ownership).' (p. 21). Even where land may be owned individually, women continue to face the problem of providing collateral, since many cultures exclude them from the ownership of land. See the country studies in Mayoux (1988, 1989) for examples from Africa.

6. In discussing problems with slow repayments in Ghana, Levitsky and Prasad note that 'Participating banks claimed that the Credit Guarantee Scheme was reluctant to settle claims. They believe that the managers of CGS were under the misconception that the measure of success of a guarantee scheme was a low pay-out rate.' (p. 69). The fact that the CGS had only paid out 0.5% of the total amount of guarantees over a ten year period of great economic difficulty suggested that there may have been some truth in the complaints of the participating banks.

7. Levitsky and Prasad quote the problems that arose in a credit guarantee scheme in the Cameroon, which had a permitted total guarantee to capital fund ratio of 7:1, but after five years had reached a ratio of only 1.6:1. The agency was severely criticised by the commercial banks for being excessively risk averse and many of them left the scheme complaining of long delays in processing applications and even longer delays in obtaining settlements to claims. However, commercial banks may also show excessive risk aversion and Adewunmi (1984) is critical of the management of Nigerian commercial banks for their high preference for liquidity and presents evidence of their failure to provide credit to agriculture.

8. In evaluating the success of credit guarantee schemes, it is important to examine default rates. The choice of measures of default rates raises some interesting technical problems that are discussed in Adams (1988), Bolnick (1988) and Padmanabhan (1988), chapter 10.

9. In some cases, rather than encouraging the FFS, governments have intervened directly to channel funds that might otherwise have gone into that sector to particular borrowers. For example, Mahat (1981) describes the operation of the Provident Fund in Nepal during the 1970s. The Provident Fund was a central agency that pooled the compulsory savings deducted from the salaries of government employees (plus savings from employees in a number of private organisations). While initially loans to enterprises formed an important proportion of the total, in the later years covered in the study, the bulk of the funds were invested in government securities or made as loans to individuals who were saving with the Fund. Some early loans to enterprises were made without due regard for the economic viability of the projects and although the loans were provided under government guarantee, this only operated after the Provident Fund had exhausted the legal process to reclaim the loan, which was time consuming. The other problem with the Provident Fund as a source of credit was the conflict between the need to obtain a high rate of return for the enforced savers and the needs of the borrowers to obtain credit at reasonable rates of interest.

10. Levitsky concludes that 'Despite efforts to encourage lending to small scale enterprises, it must be admitted that World Bank lending has hardly benefitted the very small, informal, microenterprises.' (p. 26). He also points out that these credit programmes may have distorting effects on the growth of enterprises: 'The provision of too many special benefits for the small enterprise sector can lead to the creation of "mini-conglomerates" of small businesses in place of the development of larger enterprises.' (p. 26).

11. There may be a general tendency for lending agencies to overestimate the size of the 'small' enterprises they are aiming for. For example, in examining the constraints on women's participation in a credit programme in Peru, Buvinić and Berger (1990) report that while the programme aimed to distribute loans with a mean value of US$5300 per loan, during the first four years of the programme more loans were made but less money was lent in total than was targeted for. The average loan size was US$2362 and they conclude that 'The actual mean loan size was lower than projected, in part because of the program's overestimate of the resources available to the average microentrepreneur in the pueblos jóvenes.' (p. 697).

12. In his study of pawnshops in China, Whelan (1979) traces the institution back to the last quarter of the fifth century A.D., when it was a commercial enterprise restricted to Buddhist monasteries.

13. In discussions of poverty, one additional dimension is gender. Patterns of involvement by men and women in the UIS differ across continents, depending on cultural and institutional factors. In Africa, men tend to migrate to the cities leaving women behind to work on the land, while in Asia and Latin America the involvement of women to the UIS is much larger. Sethuraman (1988) estimates that in Bangkok women constitute almost 50% of the UIS, while in Jakarta it was about 25%. In Latin America, the percentage of women in the UIS tends to high and Carbonetto, Hoyle and Tueros (1987) estimate that in Lima in

1983 only 46% of working women were in the formal sector, with the majority of those in the UIS working in commerce and, among the industrial activities, in the production of garments (often through homeworking). There is evidence in both the rural and UISs women suffer considerable disadvantages in relation to incomes and employment. For example, Sethuraman (1988) reports that in Thailand women received only 64% per cent of the wages of men in the UIS, though it is not obvious that this calculation allows sufficiently for the difference in the occupations between the sexes. Gender discrimination is also a serious problem with respect to their obtaining credit; see Rogers (1989) for a discussion of discrimination, particularly on the part of some of the donor agencies.

14. Schemes based on reciprocity which do not involve money have been developed in some rural communities. In these schemes a group of farmers agree to work together on each others land in rotation. No payments are made between the members of the group, except that each farmer is responsible for feeding the others while they are working on his land. Johnny (1985) gives examples for Sierra Leone.

15. Seibel and Shrestha (1988) report that their existence has been documented for the Yoruba in Southern Nigeria for as early as 1600. While ROSCAs are not found as widely in Latin America, Vélez-Ibañez (1983) presents evidence of the popularity of ROSCAs among Mexicans and Chicanos in the Southern United States. In Latin America, as a result of encouragement from the Peace Corps and church groups, credit unions became popular. The basic idea 'was to provide an outlet for savings that would be available as credit to the same group and to rely on voluntary contributions of labour and a 'cooperative' spirit rather than on the profit motive.' (Vogel and Burkett 1986a, p. 432). Credit unions tended to be larger and more formal than ROSCAs and often involve a more elaborate organisational structure. In many instances in Latin America they have received funds from aid organisations and they will be discussed in the second category of credit programmes independent of the FFS.

16. While it is easy to see why ROSCAs are popular among those who have little or no access to the FFS, they are also popular among wealthier members of many societies who do have access to that sector (see Cole and Park (1983) on Korea). Part of the attraction may be the absence of project appraisal and flexibility as compared with borrowing from the FFS.

17. The contrast between the distance of formal financial institutions from their customers and the proximity of lenders and borrowers in the IFS is vividly described by Timberg and Aiyar (1984):

> *The borrowers in the informal market are "known" parties - under continuous surveillance in the closely packed lanes of the urban wholesale markets. Each bale of cloth that goes in and out is observed by neighbors, the finance brokers and bankers among them; an expensive night on the town is reported and judged the next morning in market gossip. In contrast to the relatively anonymous world of Western businessmen, even in the larger metropolitan centers Indian businessmen live their lives in a narrow social ambit. Most of the intermediaries interviewed seemed incredulous at the suggestion that they would have to ask formal questions of borrowers in whose shops they visited every day and with whose business confrères they were in continuous contact.* (p. 45.)

18. Singh (1989) contains an interesting account of how loans from village temples supplement loans from money lenders in some remote parts of India. See also Nevaskar (1971) and Jones (1990, 1991) on the role of the Jains as moneylenders in India.

19. Comparing interest rates without taking transaction costs into account may be very misleading, since there is evidence that transaction costs may outweigh interest rate charges for poor borrowers. In discussing transaction costs, one should consider not only the direct costs to the lender, which will normally be passed on as charges to the borrower, but also the transaction costs that affect the borrower directly. For example, if obtaining a small loan for a short period of time from a commercial bank would involve three trips (one to collect the forms, a second to return the forms and a third to collect the loan) and if each trip involves a half day in travelling and transacting the business, the opportunity cost of the time lost in terms of income foregone may be much larger than the saving in interest rate charges between the commercial bank and the moneylender. See Christen (1989) for further examples.

20. Austin (forthcoming) reports that in some parts of West Africa the problem of collateral was solved by 'pawning' one or more people, often the lender himself or relatives, who would work for the creditor to pay off the interest until being redeemed when the loan was settled. While this system tended to become less important during the nineteenth century, Austin reports that it was revived 'on a large scale in some of the poorer areas of West Africa during the early 1930s, when the Depression reduced the meagre opportunities that had existed for acquiring cash.' (p. 27). Some cases of human pawning were recorded in West Africa in the late 1940s. While the range of items accepted by pawnbrokers is wide, Bouman (1989, p.79) reports that in India interest charges may be up to 10% per month on durables such as watches or radios, as compared to 2.5% to 3% per month on items of gold.

21. Fuglesang and Chandler (1988, pp. 55-60) describe the operating system as follows:

> *The poor who want to become members of the Bank are encouraged to form groups by finding five like-minded people who are in a similar economic condition and enjoy mutual trust and confidence. Whereas group members must be inhabitants of the same village, only one member of a household may be in a group. If several people from a household want to join the Bank, they must take membership in different groups in the centre, or in another centre entirely. Similarly, relatives must not be in the same group. Membership in groups and centres is according to gender. Women comprise their own groups and centres and so do men. This decision is given in the social milieu of Bangladesh which is predominantly Islamic.*
>
> *When a new group is formed, it is kept under close observation for a month by bank workers and other staff to see if the members are conforming to the discipline of Grameen Bank. If satisfactory, two members will receive their loans and be observed for a month or two to ascertain if they pay their instalments regularly. Only then will the next two members be eligible for loans. The fifth member of a group will receive his or her loan when the second set of loanees have established their reliability.*

The second set of loans are not approved before the individual accounts of each group member are settled. Thus, the group members interact in a micro-network of mutual accountabilities. The individual is kept in line by a considerable amount of peer pressure. Equally, an individual is sustained by a considerable amount of peer support. This is the whole basis for the singular fact that Grameen Bank can give loans without demanding a collateral surety. Social collateral replaces material collateral. The credibility of the group as a whole--and its future benefits in terms of new loans--is in jeopardy if one member defaults on loan repayments. In practice what often happens in the case of financial difficulties is the group arrives at a private arrangement to pay a member's installment. This is one of the reasons the Bank has a repayment rate as high as 98%.

A member may leave the group at any time as long as any loan is fully repaid. If a member leaves without repaying the entire loan, the responsibility for paying the balance falls on the remaining group members. Any person may join a group if its members unanimously agree and the person meets the qualifying criteria of the Bank.

***Centre meetings**. The regular centre meeting coincides with the weekly repayment of installments. ... One of the most significant features of the centre meetings is that **all bank business is conducted openly** in front of the members. There are no private transactions, much less are there any shady deals. Every member knows what is happening and can assess her or his own position in relation to others. Carrying out all transactions in public and dealing with problems together, combined with the rotation of office holders by obligatory yearly elections, severely mitigates the entrenchment of vested interests and constellations of power.*

22. The importance of peer-group pressure is confirmed by the experience of OXFAM. Devereux and Pares (1987, pp. 30-31) report a number of examples:

Various deterrents to defaulters can be built into schemes. The desire for a further interest-free loan was given as the chief reason for repaying on time by the small farmers in Andhra Pradesh who benefited from Oxfam's post-cyclone revolving crop loan scheme in 1977. Peer-group pressure also improves repayment records. In Andhra Pradesh recipients of the crop loans were obliged to give joint guarantees of security in small groups. If a member did not repay on time he was obliged to pay interest on his loan until it was fully repaid, and in addition all members of his group were denied any further loans from the bank.

Where part of the source of the credit is within the community itself, the social pressure to repay is all the greater. The Working Women's Forum, based in the states of southern India, has extended $500,000 worth of credit to groups of between 20 and 30 women. To join, each worker must pay in Rs 6 (48 cents) every month. In return they are given group passbooks, and each member can take out small loans, which must be paid back in ten monthly

installments. The interest rate is only 4.7%, but if an individual defaults, her entire group ceases to be eligible for this advantageous rate.

For a theoretical analysis of imperfect information in rural credit markets and the operation of peer monitoring, see Hoff and Stiglitz (1990) and Stiglitz (1990) respectively.

23. In contrast with the Grameen Bank and its clones in rural credit programmes, in the Peruvian experiments there are fewer restrictions on group formation. For example, there is no requirement for single-sex groups, a fact that may reflect the different position of urban women in Catholic Latin America compared with rural women in an Islamic country. The restriction of only one household member per group operates, but there is no exact equivalence in the urban setting for the requirement that group members should come from the same village; in practice the members of a group come from a small area of the city, usually from a few adjacent streets. Members of a particular group do not have to follow the same occupation. In the Peruvian schemes, saving with the lending institutions is not required of the participants.

As with the Grameen Bank, the policy of the credit programmes in Peru has been to target women in particular. It is possible that this common feature of different applications of the Grameen Bank system may have contributed to the high repayment rates obtained in these credit programmes, but data showing repayment rates by sex seem to be unavailable, so that a direct comparison cannot be made.

24. In discussing womens' microbusinesses at low income levels, Berger (1989) suggests that 'Because they exist at the margin of minimum subsistence levels, women in this group tend to be risk-averse. ... Their desperate living situations may make them eager to take loans if they can obtain them, but their loan investment is unlikely to lead to significant income expansion, and they may be forced to "divert" the loan to consumption.' (p. 1022).

25. Similar evidence is presented by Johnny (1985) for Sierra Leone, who reports that 'Project farmers are recruited on the basis of their social standing in the community. The evaluation further showed that such farmers are more committed to non-agricultural activities (such as trading) than to farming. Biasing project lending in favour of these 'rural elite' is, therefore, tantamount to promoting the flow of resources out of the agricultural sector. Evidence from evaluations of various credit operations shows that social status is inversely related to loan repayment.' (p. 26).

26. Sometimes information concerning the IFS may be revealed by regulations affecting the customers of that sector. For example, Cole and Park (1983) provide data for South Korea on the size of the IFS for the early 1970s, when a government decree required all enterprises with a business licence to report informal debts. The total reported was equivalent to 80% of the supply of money at the time and 34% of the then outstanding domestic credit of the banking sector.

27. It is likely that the impact of monetary policy may be similar on the FFS and IFS for such clients. For example, if interest rates are raised to squeeze credit in the FFS, some borrowers may shift their demand for loans to the IFS by obtaining credit from ROSCAs. One would expect this increased demand to lead to larger discounts in ROSCAs that allocate

funds through bidding and hence implicit interest rates will rise in at least some institutions in the IFS.

28. The 'inflation tax' may be defined as the product of the government's debt and the difference between the real interest rate it would pay on its domestic debt in a non-inflationary situation and the real interest rate it currently pays for the stock of debt.

29. There may be differences in the impact of the inflation tax on the poor in RTS and the UIS, depending on the degree of monetisation in the sector. To the extent that the poor in the RTS rely on non-market, subsistence production and consumption within the household, these activities are not directly affected by inflation. Possibilities for such non-market household activities, particularly in food production, are greatly reduced for those working in the UIS, who are therefore particularly vulnerable to the inflation tax. The effect of the inflation tax on the poor in Peru is analysed in World Bank (1989).

30. This role for the UIS has been noted in a number of studies. The ability of the UIS to absorb labour is illustrated in ILO (1988):

> *The **informal sector** has played a crucial role in absorbing labour and providing urban incomes in many countries. A substantial proportion of total urban employment is typically found in the informal sector - an estimated 30 per cent in Burundi, 44 per cent in Madagascar, 58 per cent in Senegal and 68 per cent in Mali. The small-scale "independent" sector may account for around 50 per cent of employment in Côte d'Ivoire, Togo and Benin (and probably others too, were data available.* (pp. 15-16).

The same report was not optimistic for the growth of the formal sector and its ability to create employment:

> *Even though the region has seen increasing production and trade in industrial goods, this has not been accompanied by a significant shift in the pattern of **employment** from agriculture to industry, as the capacity of industry to absorb labour has not risen rapidly enough. Agricultural employment engages about half the labour force in Indonesia, Pakistan, Sri Lanka and the Philippines, and more than two-thirds in India, China and Bangladesh. ...*
>
> *The increase in the non-agricultural labour force is being absorbed primarily in the service sector and the informal or unorganised sector rather than in the formal sector. The rate of growth of employment in manufacturing was much lower on average in most countries and areas during the period 1980-85 than 1975-80 (Bangladesh being an exception).* (p. 22).

Writing of Africa, Green (1989) notes that 'The key crisis forcing rethinking is the growing realisation that with three to four per cent annual economically active population growth to the end of the century, employment growth outside peasant agriculture and the large scale, capital intensive enterprise sector is essential.' (p. 49).

31. In discussing the failure of policy makers to take sufficient account of the UIS, Charmes (1990) notes that 'Keynesians and monetarists do not seem to have worked out a specific analysis of this phenomenon. All that can be said is that the planner considers the informal sector as the sands in which the multiplier effects are lost: it does not thereby blunt the effectiveness of interventionist measures, but is responsible for poor appreciation of the level required for government intervention; and the underestimation of the money supply which it represents is even less negligible and excusable because its speed of circulation is clearly very rapid.' (p. 14).

32. The ILO (1988) conclude that 'The informal sector played a counter-cyclical role in Brazil, Mexico and Peru (and where it did not, as in Argentina and Cuba, this was probably due to lower formal sector unemployment and special employment schemes, respectively).' (p. 27).

33. In discussing the problems of small borrowers, Ng (1983) concludes that:

> *Most of the studies on informal financial sector reveals that despite high interest rates, people continue to borrow from informal money market mainly because of its easy accessibility and informal dealings. Even if formal credit is available at low cost, the general tendency is that the iron law of low interest rates normally operates in favour of a few big borrowers through the operation of credit rationing ..., such that the majority of small borrowers is denied their opportunities to borrow from the formal sources. Moreover, formal credit is not provided for consumption purposes as it is usually considered unproductive. Other factors which also operate simultaneously to the disadvantage of small borrowers in their loan applications include the stringent requirement of collateral security, the formal and tedious application procedures, and the non-synchronisation of credit needs and credit disbursement.* (p. 11).

34. Seibel (1988), Seibel and Parhusip (1990), and Germidis, Kessler and Meghir (1991) contain detailed discussions of various proposals for linking the IFS and the FFS and the results of experiments in a number of developing countries.

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