

POLICY BRIEF

WHAT DOES IT MEAN TO TAKE CONTEXT SERIOUSLY FOR CREDIT AND MICROFINANCE?

Lessons from informal credit in Afghanistan

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Why it matters

Informal credit is one of the most important economic institutions for most of Afghanistan's population. If you don't understand informal credit, you cannot understand the rural economy. That makes intelligent support for rural economic activities almost impossible and investments likely to give poor results – as was the case for reconstruction efforts in 2001–2021.

During that period, misunderstanding of informal credit was bound up with other preconceptions about markets and production. An attempt to understand informal credit – already known to be hugely important – might have led to questioning other false assumptions about the rural economy that resulted in the failure of much investment.

Informal credit relations range from the highly exploitative to mutual solidarity. The health of different types of informal credit offers a useful lens on changes in poverty over time. Those who are unable to maintain a position in the reciprocal informal credit economy are those most at risk of destitution, so informal credit is also a good entry point to understand how to target food security support. These opportunities were missed in Afghanistan.

What aid programmers got wrong

Informal credit was simply ignored. If noticed at all, informal credit was seen as inferior to formal institutions and generalised. There was little appreciation of the broad types of informal credit, their different roles and what these signified in terms of support, opportunity or exploitation.

There was a common assumption that the formal is always better than the formal (seen also in regard to trade and in governance). The dominant market models also insisted that a lack of credit was holding back entrepreneurial behaviour, and thus they saw demand for informal credit as a shortage of formal credit for investment capital. Consequently, support to credit institutions was tied to false models of rural entrepreneurship.

What was wrong with the assumptions?

Informal credit is rarely for financial investment only. It is often an investment in social relations, a form of social protection, and a part of how people spread risk and build social ties that will support them when needed.

Informal credit is not simply a financial transaction. It is embedded in social relationships and can only be understood within those relationships. Within that context, for example, it makes sense for people to borrow in order to be able to lend to someone else, and not necessarily because one set of terms is more favourable than the other. Often informal credit can be costless.

By assuming that informal credit was not important, or even failing to see it at all, policy-makers failed to understand one of the most important economic institutions of rural life in Afghanistan. This contributed to a number of other mistakes that were made in development planning.

Policy implications: getting it right

- Tracking the overall health of informal credit systems is critical for understanding the local productive economy, village social hierarchies and the informal social welfare regime. Monitoring the terms and conditions of informal credit reveals its health and how it is changing over time. Seeing who is excluded from these systems because of extreme poverty can help to target social support to those most in need.
- Where formal credit systems are introduced or supported, monitoring has to go beyond relying on the project assumptions, i.e., the usual focus on the volume of loans and repayment rates. Understanding is needed of what the loans are actually used for and the means by which repayments are made (e.g., by taking on fresh debt).
- Efforts to support the informal credit system, e.g., injecting resources into the system and improving the reliability and terms of access, depend on the moral economy that exists at village level. In many places, this will support trickle-down effects, but that cannot be assumed.

Why context matters

Central to the reconstruction of Afghanistan in 2001–2021 were efforts to ‘rebuild’ a productive formal economy, particularly in the agricultural sector. The existence of informal credit systems in rural areas was known, but there were different and contradictory views on their role and significance. For donors concerned about famine in the immediate aftermath of 2001, informal credit was seen to be drying up as a source of mutual support between households. For the counter-narcotics agenda, it linked to opium poppy cultivation to support a story of excessive interest rates and ‘narco-usury’ by opium traders. And for the promoters of a modern market-driven agricultural economy, its existence was evidence of unmet demand for microcredit. Common to all these positions was a belief in the superiority of formal institutions, which were considered indispensable for the development of Afghanistan’s rural economy.

Because little attempt was made to understand informal credit or to take it seriously, it was almost impossible for economic interventions to be informed by how the rural economy actually worked, or to engage with one of the most important institutions in the survival of the rural poor. Opportunities were also lost to monitor changes in people’s degree of need.

Informal credit was only seen through the lens of *formal* credit. Formal credit is defined by a few key parameters, largely limited to contractual arrangements and interest rates. Only these aspects of informal credit were seen, leading to a failure to understand informal credit on its own terms. Access to, use of and motivations for giving and taking informal credit, and notions of interest rates and contractual arrangements surrounding informal credit are different from those of formal credit. They reflect the socially embedded nature of informal credit. Informal credit was compared to the services of formal institutions and assessed in the terms of formal credit by looking at credit (and debt) levels and interest rates (or charges). But the lack of legibility of informal credit in the terms of formal credit devalued its character and identified it as separate, if not inferior, from its formal counterpart. Yet when a formal microcredit system was introduced that gave loans for ‘productive’ purposes, field evidence showed that the loans became parasitic on informal credit systems. Interest was repaid through informal borrowing, and the formal credit was often used to meet household consumption needs rather than invested in petty enterprises. (Significantly, this was not tracked by the monitoring systems of the formal credit institutions.)

Understanding informal credit in its context

Afghanistan's informal credit systems are best understood as a critical component of an informal social protection system. Where the state is absent or extractive and the market has little formal regulation, the search for security by households can only be pursued by informal means. People have to balance securing freedom from threats, risks and hazards with maintaining some degree of individual autonomy or freedom to act. Large joint households and dependency on community may constrain individual freedoms, but they are necessary to provide that security. Informal credit is a part of those ties. At their best, informal credit relations are reciprocal between those of equal social status and they reflect a moral economy. The robustness of these networks varies according to village resources and household characteristics. Some credit relationships are more hierarchical, used by village elites to lock poorer households into dependent relations under adverse terms.

Informal credit systems in Afghanistan are widespread, and they provide significant amounts of credit in cash or kind to meet consumption needs, respond to health events, meet life events (funeral and marriage costs), and for productive or investment purposes. Most households have had confidence that they will find some means to repay the debt at some undefined future time. There is an extraordinary diversity of informal credit types differentiated by the source of credit, the value of credit, the extent to which there are charges or not, the timeframe and the means of repayment. Most frequently reported are cost-free loans from personal networks that have no fixed period of repayment and are often subject to renegotiation. These are the ones that are systematically repaid, though often not in full, because it is essential to keep credit worthiness. Many households borrow with one hand (for one purpose) and lend with another, and so deliberately enmesh themselves in multiple debt and credit relations. Reputation is central to maintaining membership of what can be called a distributional economy, the mutuality of poverty. In the absence for many of sufficient land to feed the household or of adequate employment, the ability to be able to make claims on the resources of other households becomes essential to survival. Households that prove to be unable to reciprocate in credit relations end up falling out of the system, and this is a mark of severe impoverishment. Many become dependent on alms or *zakat*.

A primary investment to secure the future of the household is through marriage. Marriages can cost from \$1,000 to \$10,000. These figures, which exceed by several fold the potential annual income (around \$750) of an agricultural labourer working full-time, are by any criterion a significant investment, and they have

sometimes been seen by outsiders as irrational. But they reveal how rural Afghan households assess their best means of securing future survival, prioritising being part of the social fabric partly because they know that they depend on those social relations in times of need for informal credit.

There are also a range of informal credit practices that charge costs. These range from traders providing food on credit to households, to advances (often known as *salaam*) of either cash or inputs against the cultivation of crops. Levels of interest can vary and, during times of conflict or deepening drought when demand might rise, so do borrowing costs. Debts are often maintained through partial settlement. Borrowing can lead to longer-term suffering. If a loan is secured by land, where the creditor gets the use of the land until the capital is repaid as a form of interest payment, then the loss of land makes it harder to repay the debt, and the loss of land may become permanent. Trust must be maintained for future potential borrowing for survival, even at the cost of selling land. Traders can use debts to foreclose on mortgaged land to strengthen their social position, while the former owners become sharecroppers on the land they once owned.

What does 'taking context seriously' mean for engaging with informal credit?

Engaging with informal credit *in its context* means understanding what roles it plays in people's lives, what people do to maintain credit relations and what kinds of conditions can accompany loans. If informal credit is understood in its context, it opens up scope to use informal credit as an indicator of welfare generally, as an indicator for targeting assistance and also as a tool for redistributing the benefits of local investments.

Because the need to use social relations to survive is critical in Afghanistan, access to informal credit is an important indicator not just of livelihoods or food security, but also of the functioning of the informal welfare regime more broadly. In this sense, tracking the overall health of informal credit systems is crucial for understanding both the local productive economy and the distributional economy (the informal welfare regime). This can be done by monitoring the terms and conditions of informal credit and also by following who is excluded from these systems because of extreme poverty.

The following efforts will enhance understanding of informal credit systems.

- The 'health' (access to and availability) of informal credit systems can be tracked best by following different households in contrasting locations over

time. A key indicator of the availability of informal credit is the charges for informal credit being offered by shop keepers.

- If formal credit systems are introduced, monitoring has to go beyond the usual focus on the volume of loans and repayment rates. Understanding is needed of what the loans are actually used for and the means by which the repayments are made (e.g., whether it is by taking on fresh debt).
- It will be challenging to target social support without understanding the dynamics of existing horizontal and vertical credit relations that are structured by village social hierarchies. One identifiable group who could be targeted at the village level is those who are excluded from informal credit and are dependent on alms or *zakat*.
- Informal systems could be facilitated indirectly through programmes that inject resources. In many places, a moral economy will support its trickle-down effects, but this must be traced and not assumed. The impacts of this on informal credit should be monitored.
- Efforts to improve the reliability and terms of access to informal credit would need to be explored at the village level where there is evidence of a strong moral economy.

Additional reading

- Kantor, P. (2012) 'Understanding informal institutions in Afghanistan'. MEI blog, 20 April (<https://www.mei.edu/publications/understanding-informal-institutions-afghanistan>).
- Kantor, P. and Andersen, E. (2010) Building a viable microfinance sector in Afghanistan. AREU Briefing Paper. Kabul: Afghanistan Research and Evaluation Unit (<https://www.findevgateway.org/sites/default/files/publications/files/mfg-en-paper-building-a-viable-microfinance-sector-in-afghanistan-jan-2010.pdf>).
- Levine, S. and Pain, A. (2024) 'Ten traps to avoid if aid programming is serious about engaging with context: lessons from Afghanistan'. SPARC Policy Brief. London: ODI.
- Shaw, T. and Ghafoori, I. (2019) *On borrowed time: the limits of informal credit for livelihood security in Herat, Afghanistan*. SLRC Working Paper 69. London: Secure Livelihoods Research Consortium (<https://securelivelihoods.org/wp-content/uploads/Afghanistan-informal-credit-cover-final-online-2.pdf>).

About this series

This paper is based on a briefing note written for the United Kingdom's Foreign, Commonwealth and Development Office (FCDO), and this version is published with their permission. It is one of series of five papers designed to help decision-makers to integrate a better understanding of Afghanistan into their work. The other papers in the series cover markets, Community Development Councils, rural differentiation and post-harvest storage and processing.

Based on the analysis of these five papers, an overview paper examines why it has proved so hard for aid actors to take context seriously (Levine and Pain, 2024). It identifies 'Ten traps to avoid if aid programming is serious about engaging with context: lessons from Afghanistan'. Although based on a study of the failure to take context seriously in Afghanistan, the paper is written to be of wider relevance.

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