Banking On the Edge

Towards an Open Ended Interpretation of Informal Finance
in the Third World

Andrew Martin Fischer
Economics Department
McGill University, Montreal
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Interpretation of Informal Finance in the Third World

By hastening the collapse of "tribalism", economists hope to move rapidly towards the day when they will understand events.

Polly Hill (1966), "A Plea for Indigenous Economics: The West African Example"

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Two people have been pivotal to my intellectual pursuits. Kari Levitt has inspired me by her human vision of world political economy and development. She has also been quick to question any of my upstart conclusions. Tom Naylor has helped me find my space and freedom within the economics discipline. Through his tireless exposition of fraud, both in the world and in academics, he has fostered a humorous relativity that has spared my mental well being. Both have continuously provided me with a refuge of free thinking at a time when ideology has increasingly charaded as science.

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This thesis is dedicated to Nathalie, because without her, I may not have even bothered.

Abstract

This thesis proposes an original framework for the analysis of third world informal finance. It will be supported by a comprehensive survey of the associated literature. Specifically, most mainstream interpretations of informal finance adhere to a dualist paradigm that revolves around three key assumptions. First that informal firms are less efficient than formal firms in conducting financial transactions, second that their activities are protected from formal competition due to segmented financial markets, and finally that the economic impact of informal finance is inferior to an overall formal system. Yet much of the qualitative evidence of informal finance contradict these assumptions and limit the validity of dualist interpretations. The dualist conclusion that informal finance is a transitory phenomena can therefore be derailed, leaving room for a more open ended interpretation of contemporary financial informality.

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Ever since social scientists have studied third world economies, they have observed that a large part of third world domestic finance operates informally, or outside of the regulatory sphere of formal states. From then on, this observation has been used to support whichever development theory was in vogue. In the 1950s, when theories of growth were popular and colonialism was still kicking, informal finance was considered by most academics and policy makers to be a manifestation of traditional (indigenous) economic attitudes. The attention towards basic needs in the 1970s led many to interpret informal finance as an adaptation by the third world poor to their marginalisation from formal economic activities. And of course, the drift towards neoclassicism in the late 1970s and 1980s generated a focus on informal finance as a mutant yet liberal response to overly interventionist governments.

Despite their variety, most of the mainstream theories on informal finance share a common denominator; they generalise financial informality as a symptom of financial dualism. According to this logic, financial markets are segmented into functionally independent sectors; the formal sector which finances mainstream economic activity, and the informal sector which finances whatever has been marginalised from formal finance. While the dualist theories may differ on the causes of segmentation, they agree that causality runs from the creation of segmented markets to the scavenging of these markets by informal firms. Correspondingly, most of these theories centrally assume that the informal scavenging is less efficient than formal finance. When added all up, they finally deduce that informal finance is but a transitory disruption, healed by formal development in the long run.

The final conclusion that informal finance is transitory underestimates the power and pervasiveness of contemporary informality. The postulates of financial dualism are only partially supported by field studies and generally ignore a wealth of contradictory evidence. Consequently, informality may not be a symptom of financial dualism and therefore cannot be generalised as a transitory phenomena.

These limitations of the dualist theories and the actual conditions of informal finance can be explored through a series of theoretical and empirical analyses. Abstract comparisons of informal and formal efficiency are largely indeterminate, and their ambiguity is further heightened when empirically applied. Since both formal and informal finance are very intertwined and complementary, empirical evidence puts into question the basic assumption that segmentation is a generalised condition of informal finance. The often innovative role of informal finance also puts into question its assumed scavenging. All of these issues put together, it seems that informal finance is more appropriately identified as one specialised extension of an overall integrated financial system, rather than as separate sector. In so putting dualism in its place, most arguments upholding the transitional nature of informality can be derailed.

Once the dust settles, the relevance of modern third world financial informality can be reassessed. Indeed, the nature of informality has been changing throughout time alongside formal financial development. As a result, static generalisations miss the point altogether. Informal finance may therefore be more subtle and complex than most academics and policy makers would like to believe. This study therefore endeavours to offer an original conceptual framework for discussing both the theory and empirics of third world informal finance.

The analysis will rely on a qualitative and descriptive approach rather than a quantitative approach. The use of quantitative methods to study informal finance poses four fundamental dilemmas. First, informal firms do not like surveys and aspire to escape most efforts to record their activities. Second, informal financial activities often show up in formal statistics where informal firms deposit with or lend from formal firms. Third, informal financial activities may show up in other economic sectors where formal businesses are used for cover. Finally, the general indirect statistics that are typically used in quantitative estimates, such as rural indebtedness or claims on the private banking sector, do not allow for the differentiation of trends within informal systems. As a result, quantitative statistics outside of case related surveys are usually unreliable.

The analysis will begin with a definition of informal finance. Accordingly, the intellectual disputes on the subject will be put into perspective with a brief review of the debates to date. The core theoretical and empirical analyses of the paper will follow along with a suggested alternative interpretation of contemporary financial informality.

Chapter One; Defining Informal Finance

While informal finance includes a wide variety of informal firms, the concept of financial informality can nonetheless be generally defined according to the institutional nature and operating methods shared by most informal firms. Institutionally, informal firms and their related activities are not fully sanctioned by the state, nor are they effectively regulated[1]. In accordance with this non-legality, both informal firms and clients almost always use personalised operating methods for both marketing and enforcement as an alternative to the legal methods used in formal finance. Along these lines, personal status replaces the impersonal legal status used in formal finance, and social accountability replaces the use of legal and bureaucratic accountability.

Personalised networking may be both the cause and effect of institutional informality. It may be the cause where personalised credit relations offer competitive advantages over formal methods. In this case, the people who choose the personalised methods are forced to operate informally due to the lack of legal legitimacy of their methods. Conversely, personalised networking may be the effect of informality when people are restricted from using the legal channels of finance, or else where formal infrastructure does not exist, forcing them to rely on alternative means.

While the whole question of causality boils down to a chicken and egg dilemma, it effectively encapsulates many of the different opinions of informal finance found in the literature. For instance, dualist authors often interpret personalised credit relations as an effect of informality, relied upon due to segmented markets that restrict access to formal finance. Others interpret informality as a chosen alternative to cumbersome formal methods, in which personalised networking is the object of choice. Yet it is precisely the fluidity between nature and method that makes informality difficult to explain on a

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[1]It is important to differentiate informal finance from the circulation of illegal money. Informal finance is an institutional term that describes the method (informal) of organising financial transactions. It does not describe the legal origin of the funds transacted. Indeed, much of the illegal money in the third world circulates through formal intermediaries, as in the case of capital flight, money laundering, or tax evasion. On the other hand, third world informal finance is usually involved with the circulation of clean funds.

general level. Rather, it emphasises the importance of looking at each case of informal finance separately.

The definition nonetheless highlights several of the common operating characteristics shared by most informal firms. For instance, the combination of illegality and personalised networking favours a minimum of overt public visibility since too much visibility strains the tolerance of the regulatory authorities. The physical scale of informal firms is therefore usually small enough to allow for both borderline legality and enforceable personal contracts, while personalised networking complements this bias by allowing for an inexpensive alternative to visibility. In addition, illegality, small scale, and low visibility all allow for an evasion of a whole series of legal and bureaucratic requirements typically enforced in formal finance.

All of these operating principles are important to understand the competitive differences between informal and formal firms, as will be discussed in the theoretical analysis. The different operating principles of informal lending generate cost structures that differ greatly from those in formal lending. Theoretical comparisons of efficiency between the two types of lending can therefore become very ambiguous, depending entirely on the context in which the comparison is made.

An Empirical Typology of Informal Finance

Beyond this general definition, the wide variety of informal firms included in the concept of informal finance needs to be typified. This is important for the clarification of any further discussion of informal finance at both the theoretical and empirical levels. The variety of firms can be typified according to their motive of organisation and their size. Informal finance is organised for either collective, associative, or commercial motives on either an individual or a group/institutional level. This typology therefore generates five types of informal finance: Collective individual finance is largely made up of non-commercial personal financial activities such as interest free inter-family loans; Collective group finance includes most forms of mutual intermediation such as savings and credit associations; Associative finance takes place where collective groups assume a quasi-public function; Commercial individual finance is essentially individual moneylending and pawnbroking; Commercial institutional finance involves veritable informal banking (see table 1 below).

Table 1; Typology of Informal Financial Firms

motive\size	individual	group/institutional
collective	personal non-commercial loans	RoSCA (rotating fund) ReSCA (regular fund)
associative (semi-public)	/	Village Association Insurance Association
commercial	Moneylenders Pawnbrokers Interlinked Credit	Finance Corporations Chit Fund Companies Indigenous Bankers and Brokers Mobile Bankers

Collective individual finance

Collective individual finance takes place for non-commercial motives among personal relations, such as family, friends, neighbours, co-workers, and even bosses. Credit activities are usually rooted in a social self help motive, and they involve a shuffling of funds between "surplus and deficit" households on a local level. It is traditionally the predominant form of lending in rural areas, especially in Africa and Asia. For instance, in the 1970s, personal loans accounted for an average of 50 per cent of loans to farmers in Africa and Asia and 10 per cent in Latin America (Ghate 68).

Collective group finance; RoSCAs and ReSCAs

At the group level, the rotating savings and credit associations (RoSCAs) are often taken to be the archetype of collective informal finance. They are found throughout the world, and have been reported since the 19th century under a variety of local names. A RoSCA is generally defined as "an association formed upon a core of participants who agree to make regular contributions to a fund which is given, in whole or in part, to each contributor in rotation" (Ardener 201). For instance, 12 people contribute 100 dollars once a month and each month, one person receives 1 200 dollars plus or minus expenses or discounts until the last round.

The variants of RoSCAs probably outnumber the amount of research articles written in their name. They can involve from two to 200 participants with an average between 12 and 60. They are used by all strata of society, though they are usually organised in homogeneous class or ethnic groups. Contributions can vary from a penny to a thousand dollars, over cycle lengths ranging from a week to several years. They can be simple leaderless groups or complex organisations with appointed salaried staff.

Nonetheless, codification has been attempted by various authors. According to popular evolutionary theories[2], the earliest RoSCAs seem to have been the labour and commodity RoSCAs. They involve non-monetary contributions of commodities such as rice or of collective labour inputs. Next comes the simple RoSCA. It uses money but does not incorporate an interest principle and rotation is socially predetermined. Variations include the lot RoSCA, where rotation is determined by lots, and the consumer durable RoSCA where the fund is used to purchase consumer durables.

The discounted RoSCA is a lot RoSCA with an interest principle incorporated through discounts. A fixed discount is taken from the amassed sum and distributed to all those who have not yet received a payment in the cycle. A participant can therefore become a net borrower paying interest, or a net lender receiving interest, depending on his or her position in the cycle. It seems to be the most popular version of RoSCAs reported.

Finally, the auction RoSCA uses competitive bidding to determine both the rotation and the discount of the fund. During a meeting, participants will bid down the value of the fund. The lowest bidder receives his bid and the difference is distributed as a dividend to all those not receiving. Thus, contrary to banks, the group determines a variable value for a fixed amount of capital, rather than allocating variable capital at a fixed value. While the auction version is popular in Asia, it seems to be rare in Africa and Latin America.

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[2] For instance, see Geertz (1962) or Nayar (1986).

Regular Savings and Credit Associations (ReSCA, Bouman 1989) are similar to RoSCAs except that funds do not rotate. Rather, the fund is a collectively organised scheme of contractual savings, acting as a do-it-yourself bank account. Deposits are regularly collected until the end of the cycle, at which point they are given back with dividends, used for bulk purchases, invested, or loaned.

Although ReSCAs are far less studied than their rotating counterpart, they appear to be as widespread and perhaps even more popular, with as many variations. Membership can vary from 12 to 80 members on average[3], and is again usually homogeneous by class or ethnic group. ReSCAs usually have an organiser, or even an executive, that manages accounts, disburses loans, and makes collections. If organisers are paid, a commission varying from less than one to 5 per cent of the contribution is usually charged (Miracle et. al. 706). Records are often kept, contributions can be variable, and discipline is maintained with severe fining policies. Loans are usually short term, to members at lower rates and non-members at higher rates.

Associative finance

Associative informal finance (Dupuy 1990) is collective group finance taken one step further. It is a quasi-public organisation that is used by a collectivity to perform functions otherwise performed by the formal state. Thus while mutual intermediation involves a contractual arrangement that can be ended, the associative "does not allow the individual to avoid the savings collection" (Dupuy 27). Thus once a member becomes part of an association, they are expected to remain.

Associative informal finance is most common in the Saharan and Sahel regions of Africa, and are cited as village associations or insurance associations. Dupuy argues that the crisis of the public sector in this region has led to an informal management of collective services outside of formal state structures. In his opinion, the associations are profoundly changing the productive systems in the region (ibid. 24).

The associations are organised among members of the same ethnic

[3]Some have been reported with more than 100 members in India (Bouman 1989 58), and more than 200 members in West Africa (Miracle et. al. 715).

group, village, or other collective unit. They function in a redistributive manner and provide both rural and urban services. While the insurance associations concentrate on insurance and social security, the village associations deal more generally with agricultural and infrastructural investments as well as social security. Urban associations are usually connected to their rural counterparts and conduct transfer payments to finance rural investments.

<u>Commercial individual finance; moneylending and pawnbroking</u>

Informal moneylending exists in every corner of the third world, as well as the first and ex-second. Moneylenders are individuals involved in informal lending for a pure profit motive. They are invariably involved with localised operations and they usually specialise in short term lending of small and often unsecured amounts. They can be professional or part-time, lending in relation to other activities, from their own funds, from deposits, or from borrowed funds.

Pawnbroking is moneylending secured against movable collateral such as gold, silver, jewellery, consumer durables, and even pots and pans. The collateral is held by the pawnbroker for the duration of the loan or until the articles are redeemed. If default occurs, the articles are kept or sold. Consequently, the usual procedure is simple and rapid with transaction costs resting at a bare minimum. The borrower arrives with the pawn, which is most commonly gold, the pawnbroker appraises the value of the pawn, and extends a loan for a certain proportion of the pawn's commercial value at an interest rate that reflects the risk of both the pawn and the client.

Given its widespread popularity in many regions, pawnbroking has been partly registered by many governments, especially in Asia. While this creates a legal difference between registered and non-registered pawnbrokers, the difference is minor and deals mainly with the legality of unredeemed pawns. Both use the same techniques, and regulation tends to be superficial, allowing for the registered pawning to underreport interest rates and income.

Interlinked credit is a variant of moneylending and is used to hedge across land, labour, or product markets. While land-mortgage and labour-bonding loans are widely regarded to be in decline, product-related loans are cited by many authors to be one of the fastest growing forms of rural lending in many third world countries. These loans are used by trader-moneylenders such as agricultural input dealers, produce dealers, or processors. Loans are extended with a purchase of an input, with a guarantee to supply output, or with a guarantee to use the marketing agent.

Commercial institutional finance

Commercial institutional finance involves veritable informal banks and financial brokers. Although they may be incorporated, their activities are effectively unregulated and they share the principle of small scale personalised networking with the other informal intermediaries. They are particularly interesting since their smallness of scale usually refers to their number of debtor clients but does not preclude large financial volumes. While they are widespread throughout Africa and Asia, the most researched examples include the finance corporations, chit fund companies, and indigenous bankers and brokers of India, and the mobile bankers of West Africa.

The Indian finance corporations are informal financial businesses that lend from public deposits (Nayar 1982 5). Although they are registered companies, they are effectively unregulated due to a loop hole between the Indian money lender act and partnership act[4]. Their organisation varies along a standard model. Ninety five per cent are partnership firms, with the rest as proprietary concerns. Their initial fund is minimally made up of subscription capital and the rest is from fixed public deposits with one to five year terms. The corporations pay commissions for the active canvassing of their deposits, and they issue pass books and cash certificates to depositors. On the lending side, they extend secured loans on collateral, unsecured loans, and instalment credit. Secured loans are usually conducted by discounting trade bills on the basis of receipts or by discounting cheques. Unlike banks, services such as chequing accounts are not offered. Low

[4]Interest rate regulations under the moneylender act only apply to loans of less than 3 000 rupees. Conversely, partnerships are only regulated if their capital subscriptions are over 100 000 rupees. Therefore, finance corporations lend in large amounts and keep capital subscriptions below 100 000 rupees in order to avoid regulation. This usually leads to extremely low levels of liquidity.

spreads are largely maintained by cost cutting on administration (ibid. 9).

The Indian chit fund companies are a commercialised version of Indian RoSCAs (ie. the chitty) run by institutional foremen (Nayar 1986 46). They are organised by registered and unregistered companies, and even by banks and the government. Nayar identifies two types of companies, the standard chit fund and the prize-lottery. The standard chit fund is run on the same principle as the RoSCA except that it is organised on a commercial basis. The organiser is a professional who takes a commission, auctions the fund, and organises the contact between the often impersonal members whom he canvasses through ads. The prize-lottery chit fund is a commercialised RoSCA turned gambling scheme. For instance, the lottery can have over 1 000 participants but only 50 draws, and on certain pre-selected draws, winners receive prizes (like cars, apartments in the city, or houses). Those who do not win any of the draws have their savings returned at the end of the cycle (50 draws), or possibly several months after, and sometimes with a bonus. While these chitties often mobilize phenomenal amounts of money, they are also the most susceptible to fraud[5] (ibid. 53).

The indigenous bankers and brokers of central India form an informal "full service" banking network that predates colonialism. The indigenous bankers[6] are essentially organised groups of informal bankers currently concentrated around Gujerati and Bombay with complex networks and associations spread across the major urban centres of central and south India. In the past, their activities have also extended across much of South East Asia. The brokers are intermediaries connecting potential lenders and borrowers, and are usually associated to various indigenous banking or broking associations. Both work out of small scale firms and specialise in particular markets where they often build up credit relations over generations. For instance, Gujerati indigenous bankers rarely have more than 200 clients per branch, and a large broker will typically work with 15 to 30 firms on both the lending and borrowing sides (Timberg and Aiyar 47).

[5]The classic chitty fraud stories in India are largely based on the experiences of these lotteries (ibid. 53).

[6]They include the Shikapuri financiers, the Gujerati indigenous bankers, the Chettiars bankers, and the Rastogi bankers.

Despite their firm specialisation, their membership to regional associations allows for access to vast informal networks of funds from other markets.

The West African mobile bankers are the equivalent of indigenous bankers. They are essentially market place bankers who organise commercial ReSCAs for market traders. They have on average between 150 and 250 clients[7] often spread out between several markets. The bankers collect deposits and lend credit daily at the market place. Their clients make regular or irregular deposits, depending on their ability to pay, and are allowed access to a line of credit (Lelart 284). Each banking cycle lasts between 30 and 150 days, after which the sum of the savings and dividends are returned minus a commission of usually one thirtieth the sum.

The empirical typology summarises most of the cited types of informal finance. Actual varieties are more extensive. For instance, finance corporations exist in almost every country of East Asia under various models of organisation. The typology nonetheless captures the essential features required to appraise the existentialist ambiguity of informal firms. It also helps put into perspective past intellectual debates on the subject.

[7] Some cases of even 600 clients have been recorded (Lelart 281).

Chapter Two: Reviewing the Intellectual Debates

There is almost an universal recognition in the literature that informal finance is at least partly beneficial for third world economies in the short term. Yet there is also a widespread belief that informal finance will not survive the eventual modernisation of financial systems. Most intellectual debates generally divide into two camps on this second belief. The first camp, which can be termed as the dualist paradigm, interprets informal finance as an inefficient transitory phenomenon derived from segmented or incomplete financial markets. The other camp, which can be termed as the dissenters, disagrees in one way or another with the a priori assumptions of dualism. Some of the dissenting authors may nonetheless contain elements of the dualist paradigm by conceding that third world financial systems are segmented. Instead, they dissent by arguing that formal rather than informal firms are inefficiently adapted to local financial conditions. This review draws on the most representative authors of each camp in order to build a general portrait of the strife.

The majority of authors on informal finance generally adhere to the first camp, that of the dualist paradigm. Implicit in the paradigm are two related notions; that informal financial firms are less efficient in conducting financial transactions than formal firms, and that, causal to this, they only exist due to the inefficiencies caused by segmented financial markets. Market segmentation protects the inferior efficiency of informal firms by blocking the entry of formal firms into the segmented markets. Accordingly, informal firms cannot help but be replaced by formal firms once financial development eliminates segmentation. Thus while informal finance may be considered beneficial or at least benign in the short term for lack of better market conditions, it is believed to be ultimately doomed to redundancy, and to be less socially efficient than a fully formal financial system.

Each dualist author has their own version of segmentation. For some, it results from traditional attitudes that sustain an irrational demand for informal finance[8]. For others, it is caused by poverty, which formal

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[8]For instance, see Geertz (1962) and Drake (1980).

intermediaries are ineffective in servicing[9]. Finally, neoclassically oriented authors claim it is due to financial repression which created a residual credit demand through government imposed credit rationing, interest rate ceilings, or mandatory credit targets in formal finance[10]. Nonetheless, it is assumed in each case that the perceived inefficiencies of the financial system are generated from outside the formal sector per se.

Authors began to enunciate dualist theories in the 1950s and tended to apply their interpretations to RoSCAs[11]. The RoSCAs were generally taken to be signs of evolution from "traditionalistic" economic behaviour to modern and rational behaviour. They were beneficial because they taught the "savings habit", a habit that would be later transferred to formal practices once the joys of modern banking were discovered. The same logic was transposed into a vocabulary of poverty in the 1960s and 1970s, again for RoSCAs. They were believed to be an ideal way to deal with conditions of low and unstable incomes. Once the same incomes became high and stable, people would again transfer their incomes to formal activities[12]. In the end, RoSCAs were condemned to be a "middle rung on the ladder of development allowing people to gradually climb to the top of modernity" (Geertz 239).

Geertz rolled out the intellectual carpet along these lines in the early 1960s. He likened the RoSCA to a "device by means of which traditionalistic forms of social relationships are mobilized so as to fulfil non-traditional economic functions" (Geertz 242). To support his thesis, he used a cross-historical and cross-geographical narration of RoSCA development, from a commodity RoSCA of a small village in Indonesia to an auction RoSCA in a larger town of India. At each step of development, he argued that the RoSCA

[9]Kurtz (1973) represents this perspective. It is generally recognised by anyone studying informal finance among very poor populations.

[10]Again see Drake (1980) or Chandavarkar (1985). Publications from a finance perspective, such as The Economist, usually treat informal finance in this way.

[11]The early studies were mainly pioneered by economic anthropologists who seemed to have been more interested in cooperative rather than commercial intermediation.

[12]Again, see Kurtz (1973).

moves away from a social function and towards a purely economic function of allocating funds at competitively determined prices. Ultimately, "the form is, perhaps, self-liquidating, being replaced... by banks, cooperatives, and other economically more rational types of credit institutions" (ibid. 262).

More recent generations have carried on the Geertz tradition. In fact, his assertions seem to be taken for granted by much of the recent literature. For instance Drake generally casts all of informal finance into an extended logic of "habit formation" in his 1980 fairly neoclassical classic on financial development. Informal intermediaries,

> ...have a most useful role to play in introducing and habituating people to financial forms and methods. From this start, people may move on to formal institutions ... In the course of economic development informal financiers and loan associations may become redundant (Drake 140).

In 1990 Callier argues that since West African ReSCAs are based on segmentation, as their economies develop, "the raison d'être of the [ReSCA] disappears" (Callier 276). Like arguments, with or without attempts to validate, can be found throughout the literature. In other words, the "traditionalistic" logic of informal finance seems to have been established as the intellectual foundation of most dualist interpretations.

From this buttress, the dualist authors generally caste a gloomy portrait of the potential side effects of informal finance. A good summary can be found in the extensive OECD survey of informal finance produced by Germidis, Kessler, and Meghir (1991)[13]. They argue that informal finance negatively affects the accumulation and distribution processes and hence the rate of economic growth, accentuates regional and sectoral disparities, distorts prices, undermines consistent monetary and financial policy, and makes economies sensitive to external shocks (GKM 55-57). In function of their evaluation, they recommend a policy approach that would eventually

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[13]The authors of this survey take a very conciliatory approach to what they consider to be two extreme interpretations of informal finance; the repression school and the dualism school (GKM 14-15). Ironically, both of these extremes fit quite comfortably into a larger paradigm of dualism and the authors do not represent any of the more radical positions of dissent to this paradigm. This is to be expected since the dissenting arguments would weaken much of their own analysis, as will be later discussed.

assist informal firms to integrate with formal finance (GKM 14-15)[14].

Dissent to the dualist paradigm predates work on informal finance[15]. Dissenting authors argue that there is no reason to assume an inefficient or transitory nature behind indigenous or informal finance. Indigenous finance is often a very rational and efficient response to socio-economic conditions and available resources, and may not depend on segmentation. Furthermore, informal finance has been and is capable of responding to the specific apparitions of modernity in the third world countries.

The classic proponents of this vision are Ardener and Hill. Ardener specifically took up swords against the linear perspective of Geertz in the 1960s. Referring to his narration of RoSCA development, she points to counter-cases where the social component of RoSCA finance is even stronger in urban, commercial, and complex associations than in the simple rural associations. She argues that "one should beware of assuming that the **economic** or **rational** aspects always predominate in the more sophisticated institutions or those with larger memberships" (Ardener 222)[16]. In addition, she points out that RoSCAs have been around as long as anthropologists have studied them. There is therefore no historical proof that they belong to any specific phase of transition to so called modernity.

Hill more generally criticises the condescendence implicit in the concept of "learning the savings habit". She argues that it is,

> ...the compartmentalism of economic life which partly explains the widespread belief among economists that savings and investment are rare, even as concepts, in indigenous economic life; the economist is so unfamiliar with the forms such savings and investment are apt to take that he does not know where to look for evidence of their existence (Hill 1966 16).

In other words, Hill points out that the indigenous, the poor, and the rural

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[14]They call this "bridge-building", and they find it to be a tolerant policy compromise between outright suppression of informal finance and ambivalent co-existence (GKM 14-15).

[15]Dissent originates from the marginalised protests against first world colonialist ideologies. These ideologies considered most of what was indigenous in the third world to be traditional, irrational, and inefficient.

[16]This is a very interesting proposition if further applied to formal financial institutions as well.

do not need to learn the savings habit since they already have it[17]. And the indigenous institutions used for saving are not transitional but simply indigenous. They have their own ancestry, historical development, and future, and need not resemble the development of European financial institutions. From her own experience of studying the West African economies, she concludes that "those who guess on the basis of Western experience are apt to go wrong even on the fundamentals" (ibid. 10).

Bouman, a student of Hill, continues this line of argument in the 1970s and 1980s. He observes from his field studies in India that informal credit markets are evolving fastest precisely in the rural regions where agriculture is the most modernised, affluence the most prevalent, and formal finance the most concentrated. Under such conditions, informal firms compete with a wide variety of financial intermediaries, both formal and informal, and invariably "survive on the basis of competitiveness, financial viability, and low cost operations" (Bouman 1989 9). He therefore extrapolates that informal firms grow fastest "where changes have been greatest and the need for novel institutions more explicit" (ibid. 118). He argues that "policy options" based on the belief that formal institutions respond better to change and affluence tend to miss the point. Informal firms often competitively anticipate the needs of new affluence far before their formal kin (ibid 10).

Dissenting authors also tend to reverse dualism and to focus on the inefficiencies generated from within the formal financial system itself. The mal-adaptation of formal firms to local third world financial conditions is typical of this focus. For instance, Bouman and Houtman argue that the rural "penny economies" of many Asian and African countries require that financial firms generate a high turnover of small loans with low risk and low costs in order to be viable. Banks simply do not have the managerial capacity to do so, while local informal lenders are already adapted to penny conditions. A variety of other authors[18] establish parallel cases in urban "dollar" economies where informal financial methods are better suited than formal methods in rapidly

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[17] She is supported by a wide variety of research by economic anthropologists since the 1960s. Savings rates among the poor and rural are often higher than their associated national averages.

[18] See Nayar (1982, 1986), Timberg and Aiyar (1984), and Ghate (1988).

supplying short-term and hassle free working capital to traders and exporters. In both the rural penny and urban dollar cases, informal lenders are generally much closer to their clientele than formal institutions, and are thus better positioned to respond to changing financial needs.

Many authors argue that the inherent conservative bias of formal firms blocks their innovative potential, leaving the prospects of financial pioneering to informal firms. Even dualist authors such as Germidis, Kessler, and Meghir (1991) admit that formal firms tend to exhibit a triple bias of preference for public over private, large-scale and upper income over small scale and lower income, and non-agricultural over agricultural (GKM 17). Bouman points out that even when economies are diversified, formal institutions are slow in supplying legitimate outlets for the savings generated from new affluence (Bouman 1989 18).

Eboue (1988) suggests an explanation for the conservatism of African formal firms in particular. He argues that in the past, commercial banks were grafted onto the Sub Sahara African economies to support colonial or MNC trading interests only and had little to do with the local daily business. Today, the banks remain oriented towards short-term trade credit, and are specialised in supplying very large volumes to the large corporate and government sectors. As this specialisation bears fruit, the banks are based on "a notion of risk that is inadequate for the local environment", leaving informal finance to serve most of the local financial needs of the population (Eboue 47-8). He therefore concludes that it is the formal institutions that are residual to local finance, and that the real problematic of third world finance is not to formalise the informal but rather to indigenise the formal.

The existential debates over informal finance reveal that the most basic assumptions cannot be taken for granted. The dissenting authors, rather than offering a complete alternative theory, simply disagree with the blanket generalisations that are made by the dualist interpretations. They support their position with a wide variety of field examples that contradict the dualist assumptions, therefore opposing the fact that any general theory can be asserted. Their dissent therefore calls for a more probing analysis into the theoretical and empirical essence of informality using the evidence supplied by both camps of authors.

Chapter Three; Theoretical Inquiry

Introduction

In much of the literature, the discussion of informal finance takes for granted several theoretical assumptions. Significant importance is placed on these assumptions as they provide the foundation for most mainstream visions of informal finance. As previously described, these assumptions can be summarised along the perspective of the firm, the market, and of the overall economic impact of informal versus formal finance. Informal firms are generally assumed to be less efficient than formal firms under unsegmented conditions, and their existence is assumed to be due only to the presence of the segmented financial markets. Their overall economic impact is consequently considered to be inferior to a fully formal financial system.

The purpose of this theoretical inquiry is to pry open and question some of these basic theoretical assumption before embarking on an in depth empirical analysis. Are comparisons of formal and informal firm efficiency possible given their very different modes of operating? Is it plausible to assume segmentation if funds and people tend to interact between formal and informal finance? And how can the economic impact of informal finance be compared to the often unstable role of formal finance in third world economies? If the assumptions are found to hold in the abstract, then this would concede substantial legitimacy to the dualist interpretations of informal finance. If the assumptions are difficult to substantiate, then their validity must be questioned and new perspectives must be explored. The inquiry will therefore lead towards a more directed empirical analysis.

The Problems of Comparing Firms

The possibility of comparing the theoretical efficiency of formal and informal financial methods can be judged through the use of simplified cost structures for both firms and consumers. The comparison of cost structures can help determine which method if any holds a comparative advantage, to what degree, and under what conditions. This can be assessed in function of firm efficiency, economies of scale, and of consumer choice.

In the case of a financial firm, a simplified cost structure can be considered per unit value of loan transacted. The net profit of handling a unit volume of loan can be considered to be the interest earned on the loan[19], minus the cost of gathering deposits and basic capital, regulatory costs[20], transaction costs, information costs, risk and default costs, and overhead costs, all in per unit terms, divided by the inverse taxation rate where evasion does not take place.

Under this schema, many of the cost variables that are important for formal firms are minimal or even non-existent for informal firms. This is most explicit wherever the legal methods of formal finance are replaced by the personalised informal methods. For instance, information costs, significant in formal lending, are practically eliminated from informal lending by the fact that credit relations are pre-established on an intimate knowledge of clients by the informal lender[21]. The enforcement of informal loans correspondingly takes place through the threat of grimacing locals, which is free, rather than through the repeated visits of distant officials who are salaried. This social accountability of informal lending is generally reported to be far more effective in minimising default than the legal accountability of formal lending[22].

The organisation of informal firms further minimalises other cost elements relative to formal firms. Transaction costs are lower in informal firms due to their evasion of the administrative and legal requirements to sanction formal loans. Non-legal status further frees the setting of interest rates, and allows informal firms to operate with no liquidity, and pay no tax. Informal labour is usually more flexible and less paid than formal labour, and informal

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[19]Both formal and informal firms invest and lend their deposits. For simplification, both firms will be considered to only lend.

[20]For formal firms this can include liquidity requirements and all of the administrative and legal costs of being a formal enterprise. For informal firms it can include costs such as bribes to regulatory officials and other costs that are required to remain informal.

[21]For instance, the indigenous bankers of India give much more concern towards the overall credit standing of the borrower, which is known, versus the specific purpose of the loan, which is left to confidence given the former (Timberg and Aiyar 45). On the other hand, formal banks tend to do the reverse, forcing them to study the credentials of each specific loan request.

[22]It seems that people care more about the opinion of their neighbour than that of their banking official.

owners often perform much of the labour themselves given their typical firm size. The size, minimum infrastructure, and low public visibility of informal firms further reduce their overhead and fixed capital costs. Finally, informal firms typically combine lending with other business activities in ways that are not legally not permitted in formal finance[23]. As a result, overhead and labour costs are often further reduced through the sharing of infrastructure and expertise between the two businesses.

In contrast, formal firms may be advantaged in transactions that benefit from legal sanction, such as large scale lending. On one hand, legality provides them access to the cheap sources of financial capital available in the national and international networks of formal funds. Formal firms can also offer services that require a legal framework in order to function, such as credit cards and chequing accounts. In addition, the legality of formal operations is usually preferred by clients who esteem status and stability, such as large corporations and governments. The viability of the formal firms is probably founded on these factors.

Nonetheless, it is not certain that these formal advantages outweigh the previously mentioned informal advantages. For instance, informal firms are very competitive within a wide variety of small to medium scale activities where legal status carries less importance and may even hinder efficiency. They are particularly competitive in lending activities that demand a minimum of managerial attention, such as small and unsecured lending in rural areas[24], or rapid short term lending in urban areas. It is therefore difficult to extrapolate in the abstract whether formal firms are more efficient than informal firms in

[23]For instance, pawnbroking is typically combined with jewellery businesses or gold smithies, and finance corporations are often organised in conjunction with trading businesses. Informal firms may also use legal businesses as cover for their activities. This has been observed among urban curb market brokers in South Korea (Cole and Park 118).

[24]Bouman and Houtman point out that even the most ardent of loan officers can annually handle no more than 200 one year loans. Yet the typical volumes demanded in the Asian rural penny economies require officers to annually handle more than one thousand one year loans in order to remain viable without subsidy. This does not consider loans of less than one year duration that are typical in rural lending, nor does it consider the high default rates experienced on formal rural loans. On the other hand, informal firms are already viable without subsidies in the penny economies (BH 85).

handling financial transactions.

The discussion of economies of scale is similarly ambiguous since informal and formal firms each have an opposite bias towards scale. Informal operating methods are oriented towards a max/min principle whereby profit is maximised while minimising scale to a point where informality is still effective. By allowing for the practice of informal methods, the minimised scale generates significant cost savings that are not applicable in formal profit maximisation. Conversely, the operating principles of formal firms are biased towards an increasing scale. Size, status, and visibility help to attract deposits, and given the formal costs of processing loans, formal firms prefer large loans. The profit maximisation of both formal and informal firms takes place at different degrees of scale and is determined by different operating principles. Any generalised comparison is difficult in consequence.

From the consumer perspective, the theoretical choice between formal and informal finance is also difficult to ascertain due to the implicit costs of borrowing that are not included in nominal formal rates. The implicit cost of borrowing, again on a per unit loan basis, equals the nominal interest rate of the loan, plus the direct taxes and transaction costs charged to the consumer, plus the indirect travelling costs and opportunity costs required to sanction the loan[25], all in per unit terms.

Again many of the implicit costs that the consumer undertakes with formal borrowing are minimal or even non-existent in informal borrowing. Since informal firms are usually close to their clients, travelling costs are minimal, and informal lenders usually undertake these costs themselves, as in the case of door to door servicing. Given that informal businesses adapt to the working needs of clients, such as in offering evening business hours, opportunity costs are also minimal in comparison to formal borrowing which can only be conducted during prime time. The speed and ease of informal transactions further minimise the transaction, transport, and opportunity costs implicit in the multiple lengthy visits to appease formal banking bureaucracies. Finally, informal firms generally do not pass on transaction, administration, or taxation fees to the borrower, as is typical in formal

[25]This can include the cost of lost labour time if banks are only open during working hours, or if it takes a day's travel to reach the bank.

lending[26].

The consumer's choice is further complicated if deposit rates are included into the cost structure. Returns on informal deposits are typically much higher than formal returns. In addition, informal firms typically offer preferential borrowing rates to their depositing clients[27]. Therefore, if the borrowing client is also a regular depositor, both the difference of returns and the preferential rates further reduce the net cost of borrowing from the particular informal firm.

Once all of the implicit costs are added up, formal loans may end out being more expensive to the average consumer than informal loans. Small formal loans become particularly expensive since the weight of the implicit formal costs become high in proportion to the total loan volume. They often out price equivalent informal loans as a result. Similarly, formal short term lending, even of large volumes, is often far more bulky than comparable informal lending, and can also be implicitly more expensive. It is therefore difficult to determine whether a consumer would prefer formal or informal finance in any particular case.

The comparison of informal and formal finance from the firm level concludes on a rather indeterminate note. Due to the very different methods used by formal and informal firms, the weight of the various cost elements in each of their overall cost structures differ in correspondence. This makes any generalised comparison of either firm efficiency, economies of scale, or consumer choice ambiguous. Rather, each specific firm comparison needs to be considered within its own empirical context.

The Problems of Comparing Markets

On the market level, the plausibility of segmentation as a general condition of informal finance can be judged in function of informal

[26]It is often cited that formal firms pass the tax on loans to the borrower. Since informal firms evade taxes, the informal consumer does as well. This is the case of formal and informal pawnbroking in Sri Lanka (BH 1988).

[27]Preferential setting of rates is particularly practised by most collective associations, and is one of the major incentives for members to participate.

participation and flow of funds. The concept of segmentation is built on a theoretical notion of independence between formal and informal finance. Either people or funds are restricted from circulating between the two financial "sectors". Restricted flow is assumed to exist either at the user end (no access to formal institutions), or the organizational end (no flow of resources)[28]. Segmentation should therefore be supported by evidence of one or the other form of restriction.

In terms of participation, the fact that in many cases the users of informal finance do have access to formal finance undermines the generalised assumption that participation is segmented. The case of segmentation would then imply that people have only a restricted access to formal funds, therefore completing their portfolios informally. Yet mixing may also arise from a rational balancing of risky higher return assets (informal) with secure lower return assets (formal). People may also be exploiting informal profits while using the legality of formal firms to whiten these profits. There is no overriding reason why one case would be more valid than the others.

Similarly, the fact that informal funds typically circulate between both informal and formal firms thwarts any generalisation that financial organisation is segmented. Where the informal funds do flow, informal finance cannot be necessarily assumed to obstruct inter-sectoral or inter-regional resource transfers. Rather, the localised activities of informal firms tend to merge with the overall financial system and the firms conduct financial transfers in an equivalent manner to the local branches of formal banks. Where informal firms mobilise savings more efficiently than formal firms, and deposit these savings with formal firms, they may even cultivate such transfers. Furthermore, where informal firms are involved in regional associations, they may themselves be involved in significant resource transfers independent of formal firms.

In other words, segmentation does not seem to be the sole condition underlying informality. Many alternative theoretical possibilities are equally plausible, especially once the previous firm inquiry is considered. Indeed, where segmentation is not a condition of informal markets, then the informal

[28]Some overlapping may be recognised, but it is generally assumed to be a redundant exception to the rule of segmentation.

firms involved must be surviving on some sort of competitive basis.

The Problems of Comparing Economic Impacts

Once the comparison of firm efficiency has become doubtful and the assumption of segmentation suspect, the last postulate to question is whether informal finance is any more debilitating for macroeconomies than formal finance. This assumption must be supported by obvious indications that formal firms have a net positive impact of their economies and vice versa for the informal firms. For instance, the presence of informal finance is often assumed to distort prices, hide credit activities, and increase consumption and hoarding (of gold for instance), and altogether destabilise fiscal and financial management in consequence[29].

Yet regardless of the negative impacts of informal finance, it seems that this assumption originates from a particular idealisation of formal finance. Third world macroeconomic instability, especially since the 1970s, has been largely generated by formal activities. Capital flight, a considerable financial destabiliser in the past two decades, has mostly taken place through formal financial networks. Even where smuggling techniques are used, they are used to overcome regulation in the transit from formal firms at home to formal firms abroad[30]. Similarly, laundering techniques logically rely on formal institutions since the purpose of cleaning is to go public. And tax evasion has known its greatest escapades since the explosion of legal offshore funds and of unregulated formal banking[31]. Finally, speculation itself can be the goal of many a formal bank[32]. In retrospect, formal finance seems to be the most

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[29]Germidis, Kessler and Meghir (1991) summarise these nuisances.

[30]See Lessard and Williamson (1987) for a thorough survey of capital flight. Germidis, Kessler, and Meghir (1991) at one point suggest that informal finance encourages capital flight. Yet they give no insight as to how this happens through the informal networks that they study, nor do they cite any of the capital flight literature.

[31]See Naylor (1987) for an account of underground finance mostly concerning formal channels.

[32]Wilson (1992) describes the inflationary speculation of formal banks in Brazil. Since 1977, the major banks have been earning sometimes over 60 per cent of their revenue from speculating and arbitraging on the inflation rate,

effective catalyst of its own instability[33].

In addition, third world formal finance is often subject to significant corruption. Authors consistently point to the misuse and manipulation of resources in many formal lending agencies whether government or commercial[34]. For instance, default rates in Indian cooperatives are usually highest among the wealthy and politically connected borrowers, since their ability to default without retribution is taken as a sign of political clout (AGV 1984). Political corruption is so widespread in the formal financial institutions of India that many of the informal collective firms refuse membership to politically active individuals (Sarap 1990, Bouman 1989). Similar observations have been confirmed from across Asia and Africa. In all cases, the avoidance of political swindles is a crucial factor in determining the popular appeal of informal finance.

Furthermore, the negative evaluation of informal evils are often unfounded. The argument that informal finance encourages consumption and hoarding versus investment usually misinterprets both informality and third world local economies. In rural cases, Ghate (1988) points out that most of the recorded consumption on informal loans is in fact productive consumption. Since rural households do not clearly divide production from consumption, a large part of so called consumption actually plays an important transformative role in local rural economies[35]. Taking this into consideration, actual conspicuous consumption plays a small role in rural informal lending (Ghate 72-3). To take an urban example, Timberg and Aiyar (1984) find that consumption plays a small part of total urban informal lending in India, with

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helping to fuel both hyper inflation and currency depreciation.

[33]The recent rise of informality in many countries may in part be a local ex post response to this chaotic financial management.

[34]See Adams, Graham, and Von Pischke (1984) for a good collection of these authors.

[35]For instance, where consumer durables such as fridges, baskets, or vehicles are considered consumption in an urban household independent from production activities, they can be considered investment goods in a household that doubles as a production unit and uses the durables for transforming and marketing agricultural produce. The same applies to food processing, education, housing.

most loans going to trade and production (TA 55). Finally, Nayar points out that the higher interest rates and shorter terms on informal loans should discourage speculation relative to the lower interest and longer term formal loans (Nayar 1982 20).

The criticism that informal finance stimulates hoarding is also misguided. Even Drake argues that hoarding gold is unimportant since monetary savings are anyways circulated into the economy. What matters is how the monetary savings are used in turn (Drake 124). Drake's logic can be extended. In the third world, gold is generally purchased from the same people who conduct pawnbroking. Gold hoarding may therefore have the double effect of augmenting the lendable resources of the pawnbroker while improving the credit rating of the gold purchaser. As long as gold is considered to be an appropriate lending collateral, then gold hoarding theoretically plays the same role as any other form of holding savings with financial intermediaries.

The discussion of economic impact is ultimately biased by the development goals implicitly valued by each proponent. For instance, if local grassroots development is valued, then informal finance may be the best way of keeping resources local and activities locally sustainable. If large scale industrial development is valued, then informal finance will invariably be considered at best marginal and at worst disruptive. Unfortunately, few researchers are on the payroll of informal organisations.

In the end, what is often at issue concerning economic impacts is the entrenched faith that formal firms are more creative and productive with their capital than informal firms. Yet this again can only be assessed in each particular case since informal firms have also been known to be extremely creative and innovative with their financial capital.

The theoretical discussion ultimately ends in a mire. Little can be determined on a general theoretical level, and the only way out is to examine the specific case studies found throughout the literature. A general survey and summary of the studies will therefore help to evaluate these issues anew.

Introduction to the Empirical Analysis; Chapters Four to Six

An empirical survey of informal finance enhances the insights of the theoretical analysis, and helps assess which generalisations if any hold. The analysis can follow the three levels of comparison established in theory; the firm and market levels, and the impacts and trends at a general economic level. At the firm level, indications of informal competitiveness are inferred from field observations of interest rates, default rates, cost efficiency, and loan volumes. Similarly, the presence of segmentation on the market level can be scrutinized by looking at who participates in informal finance, in which sectors and for what reasons, along with the linkages between informal and formal firms. Finally, while the macroeconomic impact of informal finance is difficult to verify[36], the macro discussion can be turned around. Rather than looking at impacts, hints can be obtained about the trends of informal finance by looking at informal innovations and their recorded growth and popularity.

The multitude of field evidence confirms the theoretical ambiguities. While some empirical cases of informal finance may attest to the existence of dualism, many counter cases refute the possibility to generalise. Informal firms may operate under pseudo-monopoly conditions or else under extreme competition. The variety of people, motives, and linkages within informal markets query the generalisation of segmentation. Finally, the inventiveness of informal firms along with their recorded growth and popularity confuses the judgment that informality is but a transitory trend.

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[36]Such verification should be supported by historical cases of financial development including the role of both formal and informal financial systems. This analysis will instead be limited to a more general and qualitative approach.

Chapter Four; The Real Informal Firm

Field observations generally suggest that informal firms function within a competitive margin of formal firms, especially on equivalent loan categories. In this regard, informal interest rates reflect to what degree informal firms efficiently mobilise and lend financial capital, and to what degree they are compelled to compete[37]. Default rates and cost efficiency help to decipher the competitiveness attained by informal firms. Finally, informal lending volumes reveal the magnitude to which the firms can lend while maintaining their informal competitive advantages.

Interest rates

Dualist authors often cite that segmented markets allow for uncompetitive informal interest rates in comparison to formal rates. Segmentation generates pseudo monopoly conditions in which informal rates are formed free of formal competition. The rates are therefore believed to tend towards usury.

In certain marginal cases, informal lenders do operate under pseudo-monopoly conditions. These cases include lending in remote areas, among very poor borrowers, or under conditions of extremely scarce credit. For instance in the 1960s, Nisbet estimated the mean annual interest rate of moneylenders in a peripheral and sparsely populated Chilean region to be 82 per cent a year, with a range from 27 to 360 per cent (Nisbet 76). Similarly, moneylenders in Indonesian market places are known to offer a "five and six" deal to poor or starting traders. They lend five in the morning and receive six at the end of the day resulting in 20 per cent daily interest, or 7 200 per cent annual interest (GKM 145). Finally, some moneylenders (along with most formal banks) charge a minimum of one month interest on loans, leading to very high annual interest calculations if loans are required for less than one month.

Yet most field studies suggest the opposite of these pseudo monopoly cases. Ghate points out that "nearly all the attempts reported in the literature

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[37]If markets are segmented, then efficient mobilisation of capital need not lead to competitive activities.

to estimate... the monopoly profit component empirically have found it to be either small or non-existent" (Ghate 79). Rather, the higher nominal informal interest rates can usually be attributed to several non-monopoly factors. Informal nominal rates may reflect the implicit rates of formal loans, especially on equivalent loan categories[38]. They may also reflect realistic competitive rates where formal firms are subsidised. Finally, informal rates may reflect the risk premium of dealing with small and unsecured loans that are otherwise filtered out of most formal lending and thus not reflected in formal rates. In any case, since entry into informal lending is easy, the first postulate of monopoly does not hold under most informal conditions.

Furthermore, informal credit markets are usually very competitive, even in the absence of formal firms. In most populated rural areas, there are many informal lenders serving the same market. For instance approximately sixty per cent of Thai villages have three to five informal moneylenders operating in their vicinity, not including collective associations and formal lenders (GKM 153). In urban areas, dense populations further intensify competition among informal lenders. A Nigerian study in the 1980s found 46 informal intermediaries competing in a small regional town, of which 41 were ReSCA type village associations that dominated both the formal and informal credit supply of the town (Ibe 6). Larger metropolitan centres contain even larger selections of both formal and informal lenders, often under cut throat conditions.

The competitive conditions usually result in informal lending rates that are within a relatively close margin of formal rates, or of whichever rates set

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[38]Sarap (1990) points this out in a study of formal lending in Orissa, India. On loans of 280 rupees, which she considers to be a typical loan volume to a small farmer, the direct transaction costs made up more than half of the total borrowing costs. The resulting effective interest rate of 24.5 per cent was higher than the average local moneylender rate of 21.2 per cent. On the other hand, formal loans of 3550 rupees carried an effective rate of 13 per cent. Sarap's calculations do not include the indirect costs of lost labour time and travelling, which are again higher for poorer borrowers since they have a harder time sanctioning loan transactions. Nimal (1988) finds similar results in Sri Lanka.

the competitive standard[39]. In the case of collective informal firms, such as RoSCAs and ReSCAs, most studies cite discounts and interest rates that resemble commercial bank rates[40]. Indeed, discounts and bidding on rotating funds, or the setting of interest rates on regular funds, are invariably influenced by external commercial interest rates. Merchants who have access to bank funds and are also bidding in an auction RoSCA tend to set their lowest bids to these external rates. Members of ReSCAs and other fixed fund associations similarly keep track of external rates and tend to adjust accordingly.

In the case of commercial informal firms, their freedom to set interest rates allows them to discriminate against risky clients on the basis of price and not on the basis of exclusion, as is common formal practice towards precarious clients[41]. Their rates therefore tend to vary much more than formal rates, reflecting a variety of clients and loans from the small and unsecured to the large and secured. For instance, pawnbrokers charge variable rates that reflect pawn risk and client risk. Interest rates tend to be higher when the pawn has a lower resale potential (ie. consumer durables versus gold), when a higher proportion of the pawn's value is extended in credit, or if the client is known to be risky[42]. Similarly, the higher average rates of individual

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[39]In many cases, formal firms may be pressured by informal firms. For instance, banks in Nepal have come to see the rise of urban RoSCAs as a serious competitive threat (SS 1988).

[40]Collective rates vary according to rotation and membership. Nayar gives an example of an Indian auction RoSCA with twenty members. Fifteen were net borrowers, only five of which paid an interest rate above 20 per cent a year, the highest at 26.9 per cent (Nayar 1986 45). Annual ReSCA rates vary from five to 60 per cent, with lower rates offered to secure members and higher rates to unsecure non-members (Bouman 1989). The above mentioned Nigerian ReSCAs charged interest rates varied from 10 to 30 per cent per annum, averaging at 21.5 per cent on average loan durations of 5 months (Ibe 10).

[41]Since formal firms are limited in their ability to use variable rates for client discrimination, they mostly discriminate through user costs or else by refusing to finance. See Ramos (1989) for an interesting neo-Keynesian perspective on this rather non-neoclassical formal banking practice of adjusting to financial markets through volumes rather than prices.

[42]Bouman points out that redemption is more profitable than default for pawnbrokers. Rates therefore correlate with the potential losses of default. This considered, he notes that Indian informal pawning rates are remarkably

moneylenders usually reflect the degree to which they finance small, short term, and unsecured loans rather than any degree of usury[43].

Since the larger commercial informal firms tend to privilege large and secure clients, their lending rates are closest to formal rates. For instance, the Indian finance corporations extend secured loans at annual rates as low as 18 per cent[44]. These annual rates are particularly competitive since the finance corporations often lend for very short terms yet charge daily interest. Since formal firms charge interest in bulk one month portions, the cost of borrowing for less than one month can be considerably cheaper with the finance corporations, even though their annual nominal rates are higher (Nayar 1982 14). They also offer complete packages of services with their trade and export loans, including items such as raw material purchase and shipment of goods (ibid. 15-17). Similarly, Indian indigenous bankers typically charge a one to three per cent premium on annual formal commercial rates and brokers charge an additional 1.2 to 4.8 per cent of their turnover (TA 54). The small premium on these loans is usually comparable to the implicit costs of comparable formal loans. Large secured loans on South Korean curb markets are typically extended at monthly rates ranging from three to four per cent on terms of no more than one month (CP 120).

In some cases, nominal informal lending rates may even be lower than formal rates. The cases may be oriented towards sustaining extra-economic

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consistent between 1.5 and 3 per cent a month on average advances of 75 per cent of pawn value (Bouman 1989 68). In Sri Lanka, rates in the 1980s ranged from four to seven per cent, reflecting the abnormally high nominal formal rates during the same period (BH 81).

[43]Average recorded moneylender rates nonetheless tend to stick within a reasonable range of formal commercial rates. Annual moneylending rates in rural India were considered in 1988 to be at an average of 21.2 per cent (Sarap 1990). Moneylender rates in the Nigerian town studied by Ibe varied between 21 and 30 per cent, and were in the same range as 63 per cent of the local mutual associations (Ibe 9).

[44]Secured loans are usually sanctioned on demand promissory notes, on tangible assets, on transport receipts and invoices, or on gold pawns. Unsecured loans are also extended at annual rates varying from 20 to 36 per cent to export and textile sectors (Nayar 1982 15-17).

relations, such as a landlord trying to maintain peasant loyalty[45]. The cases may also be competitively rooted where informal firms are more efficient than formal firms in mobilising savings. For instance, some collective and associative informal firms undercut formal rates on large loans to trusted members. And Indian indigenous bankers have been recorded to beat formal rates on large and secured volumes in metropolitan markets (TA 54).

On the twist side, recorded informal deposit rates and returns are almost always higher than formal deposit rates. For instance, creditors in a discount or auction RoSCA can typically earn more than ten or even twenty per cent return on savings per annum, while formal deposits exceed no more than five or at best ten per cent[46]. ReSCAs with loan facilities often generate even more substantial returns. The Indian ReSCAs studied by Bouman (1989) often earn between 30 and 60 per cent return on a member's savings if the member takes no loans, and if loans are taken, the returns considerably reduce net borrowing costs. Indian finance corporations offer annual deposit rates from 12 to 18 per cent with some compound rates reaching 28 per cent per annum if deposits are held for five years (Nayar 1982 13)[47]. In most recorded cases the returns exceed those of any comparable formal assets.

Small informal spreads relative to formal spreads establish the competitiveness of rates on both pricing ends. For instance, finance corporations often operate with spreads of only two to three per cent while their formal competitors operate on four to six per cent (ibid. 26). The small spreads are attained through the cost efficiency of informal operations. The

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[45]In this vein, Nisbet found Chilean landlords lending to peasants at rates that were less than inflation and even at negative nominal rates.

[46]Bouman (1989) gives an example of a sample RoSCA with a three per cent discount (ie. 300 rupees taken from 9600). With twelve participants and a cycle of 95 days, the last person to draw received a seven per cent return on savings for 95 days, or 27 per cent per annum (Bouman 1989 54). In Nayar's (1986) previous sample auction RoSCA the last person in the rotation made a return of eleven per cent per annum (Nayar 1986 45). In both cases, formal savings deposits earned about five per cent per annum. South Korean RoSCA participants often lend their lots, earning an estimated average of four per cent per month on their savings in 1971 (CP 115).

[47]The high cost of deposits results in a fairly high cost of funds, explaining their margin on lending rates. They also compensate by cutting costs and by adapting their services, such as by offering daily interest.

most obvious aspect of this efficiency is the practical inexistence of default on informal loans compared to formal loans.

Default rates and operational cost efficiency

The low default rates experienced by informal firms are rooted in the use of personalised credit relations and social accountability, shared by all informal intermediaries. As discussed earlier, these informal methods replace the costly and often ineffective legal methods of formal firms. The informal firms are therefore saved from the debilitatingly high formal default rates through the use of costless social coercion.

Collective informal firms are the most effective in enforcing social accountability. For instance, RoSCAs members are usually mutually selected from only the trusted. New members may even have to prove their reputation by taking the last draw of their first cycle. Furthermore, news of default spreads rapidly, and defaulting participants can be barred from participating in other RoSCAs or with other informal intermediaries. The advantage of this communal scrutiny is that RoSCA membership can be used as an informal vehicle towards building a public credit rating (AC 233). ReSCAs extend the same principles to lending, and given that they are often involved with other financial intermediaries, their influence can even be more far reaching than that of the RoSCAs. The quasi-public authority of associative financial organisations make them even more powerful, since bad behaviour can incite effective communal banishment.

As a result, default is almost non existent in collective associations. Both RoSCAs and ReSCAs are widely reported to have almost no bad debt losses (Bouman 1989 62). A 1974 study of 18 Nigerian RoSCAs found the average default rate at 0.64 per cent of funds (MMC 713). Indeed, RoSCAs are particularly interesting in this regard since their activities take place with almost no liquidity, yet with very little risk.

Commercial informal firms essentially use the same methods although without the collective legitimacy. As a result, they also achieve default rates that are much lower than formal rates. All over Asia, pawnbrokers record very low default rates in both public and private operations[48]. Indian finance corporations record minimal defaults compared to the performance of equivalent formal lending (Nayar 1982 21). Like the RoSCAs, the low default rates of the finance corporations allow them to operate in risky credit markets despite their low levels of liquidity (ibid. 30). Risk in informal credit markets is therefore almost entirely counter balanced by the informal methods that formal firms are unable to emulate.

Obviously, the more impersonal an informal firm becomes, and the more their methods approximate formal methods, the more the risk of default increases. The classic fraud cases come from the large commercial chit fund companies in India where participation is completely impersonal. Yet these cases are usually generated by overblown scale, and not by professionalised activities per se. Professional operations that are maintained within a smaller scale need not jeopardise the advantages of personalised local knowledge. There are many examples of ReSCAs and finance corporations that have become very professional yet preserve their low default levels and personalised credit relations.

In this sense, the operating methods that minimize default are precisely enforceable given the smallness of scale of most informal firms. For instance, finance corporations and indigenous bankers usually limit their debtors to a number that they can still effectively monitor and socially persuade. Larger informal intermediaries, such as mobile bankers or village associations, are usually supported by deep communal or ethnic bonds or by larger economic networks that maintain discipline in credit relationships.

The advantages of the informal methods used to achieve low default rates are extensive. First, the informal firms obviously save the direct costs of default typically absorbed by formal firms. Second, since informal enforcement takes place organically through the community, it is also cheap. The costs of ex ante preparatory security or of ex post follow up and enforcement are therefore negligible in informal firms while significant in formal firms. Finally, the track records of low default provide the informal firms a high degree of security in their lending operations. As a result, they

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[48]Even the Indonesian government pawning monopoly achieves redemption rates of over 95 per cent (Bouman 1989 74).

can push their lending capacities to limits never dreamed of by formal firms, as illustrated by their typically low levels of liquidity.

Low informal spreads are also bolstered by the operational cost efficiency of informal firms relative to formal firms. Informal administrative and transaction costs are usually much lower than those of formal firms. The mutual administration of collective associations makes them especially effective in cost cutting. Much of their labour and infrastructure required for regular operations are supplied voluntarily. Their administrative meetings often cost no more than the goodies eaten. Where costs do exist, such as to pay an appointed professional organiser or executive, they are usually incorporated through one fixed and agreed upon commission taken out of each contribution[49]. The commission therefore covers all costs in one bulk sum and is less cumbersome than the formal practice of charging small user costs everywhere besides on deposits. All of these factors usually allow the collective associations to mobilise and lend financial resources at much lower costs than formal intermediaries.

Commercial informal lenders also possess a combination of low information, transaction, and administrative costs. Pawned transactions are particularly efficient since information costs are negligible beyond appraisal, loans have no conditionality, there are no legal or contractual fees, and there are no follow up costs in the case of default. Similarly, moneylenders work out of minimal infrastructure and with almost no administration, basing their activities entirely on personal bonds. Even larger commercial lenders such as finance corporations or indigenous bankers operate on the similar principles of minimised fixed investment and working capital expenditures. As a result, while their cost of funds may be slightly higher than formal costs, they are able to reduce other costs where formal firms cannot.

Volume

The recorded loan and deposit volumes of informal firms reveal that the firms can reach significantly large volumes without losing their informal

[49]Commissions are typically between one and five per cent. Since an organiser usually covers default, the commission partly reflects the cost of a possible default. It is also used to pay the labour and responsibility of the organiser (Bouman 1979 263).

competitive advantages. For many, smallness of scale applies specifically to their number of borrowers rather than their volume of funds. A small number of debtors is purposely maintained to keep informal enforcement effective. Conversely, since enforcement is not important on the deposit side, informal firms can often deal with over a hundred depositors at a time. In consequence, where large volumes are amassed, they are either lent out in many small amounts to closely associated collective members, or else in a few large amounts to the most trusted and secure debtors of a commercial firm.

Most collective informal firms regularly mobilise large volumes of savings. For instance, a 1978 survey of a Bangkok squatter settlement found that an average of 36 per cent of their income was saved through RoSCAs with an annual volume of over nine million US$, used largely for housing development (Ghate 69). Nepalese businessmen were observed running RoSCAs in the 1980s with total turnovers exceeding one million US dollars in local currency (SS 193). In Cameroon, large ReSCAs have been known to generate up to 20 000 dollars US of credit per month in the 1970s (Haggblade 35). In several village studies conducted by Bouman (1989) in India, the volume of funds collected by ReSCAs often exceeded the volumes available from local formal sources (Bouman 1989 64)[50]. And a typical monthly operating budget of an East African village association ranges from one to three million francs CFA[51] (Dupuy 28).

While much of these collective funds is used for small scale credit to members, many collective associations also take on major public investments with their amassed sums. The Ethiopian mahabers offer an excellent example. They are associative investment groups organised among urban dwellers from the same village. They finance village public infrastructure such as the building of schools, hospitals, community halls, or grain mills. In one case, a coalition of mahabers was reported to have constructed 256 km of roads connecting several villages in the same region (MMC 717).

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[50]In one village, eight ReSCAs together accumulated 342 000 rupees per year, or ten times the local urban credit society (semi-formal), and equal to both of the local government credit societies (PACS; formal). In another village, one ReSCA alone accumulated 450 000 rupees per year, which was greater than the local PACS (ibid 64).

[51]Approximately four to twelve thousand US$ at 1989 exchange rates.

Commercial informal firms are also capable of mobilising and lending significant volumes of financial capital. Average individual moneylenders do not apply in this case since they largely specialise in small and unsecured lending. On the other hand, many large moneylenders, pawnbrokers, and most institutional lenders specialise in lending larger informal volumes. For instance, a case study of two private pawnshops in an affluent agricultural district of India found their loan volumes to be two and three million rupees versus the 152 000 rupees of the average local rural bank. The typical volumes pawned by the local shops ranged from 100 to 50 000 rupees in public houses and from 50 to 10 000 rupees in private houses (Bouman 1989 68). On a slightly larger scale, the Indian indigenous bankers tend to limit their exposure to 25 000 rupees per loan, while brokers can mobilize hundreds of thousands of rupees. The related associations of both indigenous bankers and brokers can also give them access to large regional pools of capital (TA 46). Similarly, the standard Indian chit funds can typically mobilize up to 200 000 rupees each draw (Nayar 1986 48). Finally, loan volumes transacted in the South Korean curb markets in the 1970s were relatively large, anywhere from 500 000 to 100 million won[52], and have since increased (Cole and Park 119).

Large volumes have been observed among West African mobile bankers as well. Lelart identifies one mobile banker in Benin with 200 clients who collected over 70 million francs CFA[53] during one year of operations in the late 1980s. Another survey of 1392 Beninese market women tissue sellers found a similar amount saved through mobile bankers (Lelart 287). Also in Benin around the same time, a study estimated that more than seven million francs CFA were collected monthly from 152 traders in a minor retail food market of Cotonou (LG 81).

The mobile bankers along with several other informal intermediaries do transact with a large number of debtors. One excellent example is an informal bank observed by Bouman in India. At the time it had over 2 500 members, sixty per cent of whom were women, and served nine villages. It originated in 1983 as a steel pan commodity ReSCA, but since evolved into a literal

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[52]At current exchange rates (end of 1993) these volumes are approximately equivalent to a range from 650 to 125 000 US$.

[53]Approximately 230 000 US$ at 1989 prices.

banking institution with trained and salaried employees who conducted daily deposit and loan transactions door to door. Despite its size, the entire operation was conducted informally and had intentions to remain so (Bouman 1989 64). Other large examples include village associations with several thousand members. The examples are usually limited to cases where social cohesion is strong enough to establish discipline among numerous ranks.

In other words, despite the tendency of informal firms to work out of small establishments and (usually) with a controllable number of clients, they are no small fish in financial waters. The volumes of funds that go through informal hands may be small in the case individual moneylenders or puny collective associations, but it need not be. Many informal firms deal with volumes that can satisfy the working capital requirements of local small, medium, and even large businesses, especially in the commercial institutional lending category. These informal financial firms may therefore be involved in markets that are plausibly financed by formal firms as well. This leads straight into the issue of market segmentation.

The empirical analysis of informal firms suggests that the firms quite likely compete well among both other informal firms and formal firms. Not only are their average effective interest rates usually within competitive margins of formal rates, but their operations are often less costly per unit loan transacted, and varied in their size and services. If this is generally the case, then the issue of market segmentation may not be as critical a condition of informality as it is typically made out to be. Nonetheless, the examination of informal markets still holds some valuable hints.

Chapter Five; The Real Iinformal Financial Market

On the market level, it remains to be seen whether segmentation can be considered the dominant characterisation of informal financial markets. As discussed earlier, dualism can be proven if the informal markets are segmented into operationally independent sectors, in terms of participation or of flow of funds. Accordingly, restricted access to formal finance should be the primary reason for using informal finance. These assumptions can therefore be tested by looking at evidence of who participates in informal finance, in which sectors, and for what reasons, along with the operational linkages within informal financial systems.

Who makes the mischief

Case studies reveal that all strata of society participate in informal finance. As such, the user types cannot be generalised. The best and most studied examples in this case are the RoSCAs. All over the world RoSCAs are used by poor as well as rich, from poverty stricken shoe shiners, to middle income farmers, shop keepers, and salaried workers, right up to affluent government professionals and private business people. RoSCAs have even been reported among employees of many Latin American and African central banks and of the IMF in Washington (AC 220).

Other informal methods are also used by an equivalent variety of people. For instance, moneylenders are regularly used by the very poor, but they are also used by the middle class and the rich. In addition, many people become moneylenders. In India, anyone with a regular income or access to bank lending, such as civil servants, teachers, clerks, or established farmers, often part time moneylend and pawnbroke within their communities (Bouman 1989 86). Finally, commercial institutional informal firms are organised and used primarily by traders and businesses.

Nor is there any particular sexual homogeneity in participation. In West Africa, women dominate most of the major informal financial activities (MMC

717-19)[54]. The same was traditionally true in Vietnam (Ardener 210). One study in Bolivia found that sixty per cent of RoSCA members surveyed were women, along with the majority of organisers. Conversely, men usually dominate informal finance in India, Central and East Africa, and the Middle East. For instance, one survey of Indian ReSCAs found that 90 per cent of members were male (Bouman 1989 58).

Within this range of participants, the affluent are often the ones who are increasingly using informal methods and drawing many of the benefits. It is interesting to note that some of the newer and rapidly growing forms of informal finance, such as ReSCAs and mobile banking, precisely require stable incomes. They therefore tend to proliferate among prosperous populations, such as affluent market traders, farmers, or educated and urban middle classes. Affluence is also evident among the users of Asian auction RoSCAs, including many merchants and business people. Finally, the larger commercial institutional lenders in Asia are mainly used by medium and even large businesses. For instance, brokers on the South Korean curb markets mostly lend to large corporate firms, government officials, large informal lenders, and other large magnets of the Korean business world (CP 119).

In opposition, the truly marginalised third world poor tend to be excluded from most informal as well as formal lending activities. For instance, the shoe shiner in Bombay who contributes a penny per day to a peer organised RoSCA usually has no access to other lenders, whether moneylenders and larger RoSCAs, or formal cooperatives. His supplier or boss may of course act as a moneylender and extend credit at probably expensive rates. These cases typify poverty dualism. Yet with some exceptions[55], informal firms privilege the people who have enough wealth to generate profitable ventures, in much the same way as formal firms. Poverty dualism can therefore take place in both informal and formal systems.

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[54] Miracle et. al. argue that most West African mobile bankers are members of large regional cartels dominated by economically powerful women. In their study of these cartels, four of the most powerful cartel heads identified were women (ibid. 717-19).

[55] Exceptions include associative firms that assist their less fortunate members. Yet these associations play an important public role that stretches beyond poverty assistance.

Beyond the marginalised poor, many users of informal finance have regular access to formal finance. It is common that people draw on formal credit while participating in RoSCAs and ReSCAs. Moneylenders use formal loans as lending capital, and their clients use their informal loans to sanction formal loans[56]. For these users, informal finance plays one strategic part of an overall portfolio of activities. As a result, formal financial deepening has tended to multiply their potential sources of credit rather than to replace their original informal sources.

Where do they play

The question of where informal activities take place can be revealed through the evidence of the sectors involved and the uses of informal lending in each sector[57]. Informal finance is spread across a wide variety of economic sectors in a wide variety of economic activities that are not necessarily the victims of segmentation. These sectors are urban and rural, ranging from traditional artisan production and peasant agriculture to modern manufacturing, trade, and agroindustry. The loans are used for everything from household consumption to working capital and fixed investment.

The rural urban divide generally follows demographics. It has been well established that informal lending has predominated rural third world credit markets right up to the 1980s[58]. Yet the migrating third world masses have

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[56]See Bouman (1989) for many such examples.

[57]Most of the literature mixes up these two concepts. As a result, they have to be treated simultaneously.

[58]Various qualitative survey results from across Asia and Africa confirm the predominance of informal finance in rural areas right up to the 1980s. For instance, rural informal credit was estimated to represented 63 per cent of total rural credit in Bangladesh in 1974, 62 per cent in Peninsular Malaysia in 1986, 50 per cent of average outstanding loans to agricultural households in the Republic of Korea in 1981, and 52 per cent of new rural loans in Thailand in the early 1980s (Ghate 65-66). In Africa, it is estimated that 87 per cent of farmers in Zimbabwe used informal sources of credit in 1986, 95 per cent of loans to farmers in Nigeria were informal, and 43 per cent of farmer's credit needs in Zambia were supplied by informal credit. In Latin America, 50-55 per cent of agricultural financial needs in Mexico during the 1980s were covered informally (GKM 44-45).

carried their practices into the cities, and the urban congestion seems to have only encouraged their financial complicity. As a result, urban informal finance is flourishing, as evidenced by the rise of urban institutional firms across Asia and Africa[59].

Informal practices may even originate from urban areas. Adams and Canavesi point out that RoSCAs in Bolivia are largely an urban phenomena, and that rural RoSCAs are primarily used by merchants and professionals of urban origin (AC 224). In India, the indigenous bankers and brokers surveyed by Timberg and Aiyar were practically uninvolved in agriculture (TA 48). Schrader notes that the indigenous bankers have been urban at least since the British came to India. And many of the more recent types of informal firms, such as ReSCAs, are specifically tailored towards regular incomes, which are typical among urban dwellers versus the irregular incomes of rural inhabitants.

The variety of sectors can be typified according to their rural or urban character. The sectors and uses that are characteristic to rural informal lending entail working capital and fixed investments in agriculture and public infrastructure. Informal working capital finance is involved in almost every step of the agricultural production cycle. ReSCA cycles often mature just before harvest when large bulk sums of saving are required. Marketing agents also get involved at this stage. Input suppliers, moneylenders, and other small scale lenders supply regular credit lines throughout the planting and growing seasons when farmers may be short of cash. In the case of crop failures, village associations may insure the farmer.

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[59]Ironically, statisticians usually estimate the gross size of informal finance by looking at the ratio of rural indebtedness to claims on the private banking sector. This approach is epitomised by Tun Wai (1980). He conducted aggregate quantitative surveys every ten years since the 1950s in order to record the trends of informal finance in various third world countries. Using the above mentioned method, he estimated that in the 1950s the "unorganised" financial sector was larger than the "organised" in half of 16 sample countries in three continents, while in the 1970s, only three out of 17 sample countries had an unorganised sector larger than the organised (Tun Wai 259).

Yet Tun Wai's approach critically misses the urban shift in informal finance. The change in his relative shares between the 1950s and the 1970s may simply represent the rapid urbanization of the countries in question. In any event, he ignores the rapid growth of urban informal finance. His trends are therefore extremely limited.

Fixed agricultural investments complement this cycle. RoSCA lots are used to make periodic fixed investments throughout the year, often consummating the bulk annual cycle of the ReSCA (Bouman 1979 266). Trader moneylenders, such as the Indian milk collectors studied by Bouman, finance the capital purchases of their suppliers, such as cows and buffalos (Bouman 1989). In Cameroon, ReSCAs have been used as a source of starting capital for a brewery and other major rural businesses (DeLancey 1977). The West African village associations take on even larger fixed investments by buying machinery or by setting up mills, as previously mentioned (Dupuy 1990).

Rural investments on infrastructure are usually undertaken by the larger collective and associative firms. The West African village associations are particularly involved with public investments by building access routes, community halls, or schools (Gerdes, Dupuy). The 256 kilometres of road constructed by the coalition of Ethiopian mahabers provides a good example (MMC 717).

The sectors and uses that are common to both rural and urban informal lending include household and social consumption, housing, transport, and social services. Household consumption is typically financed by the smaller informal lenders, such as moneylenders, pawnbrokers, RoSCAs, and ReSCAs. Social consumption, the money saved and spent on annual festivals or migrations, is more specifically financed by collective associations such as ReSCAs that mature in annual cycles. Surveys of informal firms usually estimate that ten to twenty per cent of informal loans are used for these forms of consumption[60].

Housing and real estate seems to be a fairly major sector of informal finance, and is financed both collectively and commercially. For instance, in Thailand, RoSCAs have been one of the main sources of finance for housing, particularly in the Bangkok region (Ghate 69). Building societies, a specific type of Indian finance corporation, are almost entirely specialised in real estate finance (Nayar 1982).

Transportation is again another sector that is heavily financed informally. A study in 1965 in Cameroon identified investment associations (mandjon) that were used to set up cooperative taxi and transport businesses.

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[60]For instance, see Osuntogan 257 and Nayar 1982 18.

At the time, the mandjon had monopolised all of the taxis in the main cities and all of the road transport in south and south west Cameroon (Bouman 1979 272). Similarly, the numerous informal transport businesses that have grown out of the public transport crises in many Latin American cities have been mostly financed informally (DeSoto 53).

Finally, associative organisations in Sub Saharan Africa supply significant social security to members in both rural and urban areas. For instance, village associations typically cover medical costs including hospitalisation in the case of sickness, repatriation, funeral costs, and survivor's benefits in the case of death, education costs, transfer payments, among other services (Dupuy, Gerdes).

The sectors that are particular to urban informal lending are trade and industry. Large informal firms dominate these sectors across Asia and Africa. In India the indigenous bankers and brokers are estimated to supply on average 20 per cent of the credit needs in the various market categories. This includes 50 per cent of the working capital in the Calcutta wholesale cloth trade, 20 per cent in the national grain trade, and 15 to 30 per cent in the Gujerati tobacco trade (TA 54). Both the indigenous bankers and the India finance corporations are also heavily involved in financing exports. For instance, an estimated 35 per cent of Indian finance corporation loans are extended to trade and export (ibid. 55, Nayar 1982 27). And the indigenous bankers of West Africa play a similar if not stronger role in regional trade (MMC 719, Osuntogan 255).

While small and medium scale enterprises are regular industrial clients of informal firms, large scale industries may also go shopping for informal bargains. Across Asia informal finance is becoming central in financing the working capital requirements of many formal manufacturing firms (Ghate 67). It is estimated that one third of all Taiwanese private sector investment and working capital to date comes from informal sources, and specifically two thirds among small and medium sized private enterprises (Lee 36, Economist 37). An India Banking Commission estimated in 1981 that the indigenous bankers and brokers supplied one twelfth to one half of all credit to the various categories of industrial units in India. In addition, an average of seven per cent of their total lending is to large industry (TA 54). In South Korea "practically all of the large and reputable corporations classified as the prime enterprises by the BoK borrow heavily" in curb markets (CP 120).

It should be noted as a corrollary that the sectors involved with informal finance may or may not be financially segmented or rationed. In rural cases, while some agricultural regions or sectors have no access to formal loans, other do have access. In fact, informal firms tend to proliferate in the same sectors that are preferred by formal firms. For instance, Bouman's study of a rapidly growing and modernising Indian rural district points out that the greatest concentration of ReSCAs are found in the commercialised irrigated areas that also have easiest access to formal lending (Bouman 1989 64). And Ghate points out that in many countries the rural informal firms have been more successful in reaching state prioritised sectors than the state subsidised formal firms (Ghate 68). In other words, the rural informal firms bite the same profit bait that formal firms like to bite.

A similar situation can be pointed out in the lending to urban trade and industry. On one hand, trade and some manufacturing sectors are often financially repressed. In Korea and Taiwan, credit rationing and heavy formal regulation forces most of the unprioritised sectors to rely on informal finance to cover their working capital needs (Lee, CP). Ghate also points out that the traditional association of informal finance to trade in Asia is due to the higher incidence of credit controls on trade than on manufacturing (Ghate 67).

On the other hand, some trade and industrial sectors use informal finance for competitive reasons. This is the case of the trader moneylenders in the new Mexican agroindustries. The traders are primarily used by the agroindustries for their ability to inexpensively secure agroindustrial inputs from the small scale and dispersed farmers (GKM 190). Industrial informal subcontracting[61] may use informal finance in a similar competitive fashion. Many other non-rationed sectors also use informal finance, such as agricultutral trade in India[62]. And even prioritised sectors in Korea and Taiwan continue to shop on the informal curb markets (CP 120).

Financial repression therefore cannot generally explain the existence of informal finance in the urban trade and industrial sectors. The literature

[61]See Benton for a study of this in Spain.

[62]Although many of these sectors may be freely rationed out of commercial bank lending due to their riskiness.

on informal finance confirms this ambiguity. An econometric study of ten third world countries across three continents and with a variety of financial regimes by Germidis, Kessler and Meghir found that there is no necessary correlation between the degree of repression and the degree of informality in any particular country[63]. In both Korea and Taiwan in the 1980s and 1990s, attempts to soak up informal liquidity by opening non-rationed private formal banks had little observed effect on the presence or interest rates of the curb markets (Economist 37). Nayar (1982, 1986), like Bouman, also notes that urban informal finance is usually the most vibrant in regions that have experienced recent and dramatic formal financial deepening, such as the south of India.

An opposite case can be made for financial repression. In India the only policy approach in the recent past that had any notable impact on the presence of informal lenders was that of all out repression[64]. This was a far cry from liberalisation, and even paralleled increased government intervention in the formal financial system. In other words, untangling the reasons for the widespread presence of informal finance in most sectors needs to go much further.

In the end, the importance of financial repression can be better judged by looking at the reasons why people use informal finance. Under repressed circumstances, people would theoretically go informal because of restricted access to formal financial channels. Yet this case seems far from exclusive.

Why are they naughty

People use informal finance for as many reasons as there are people participating. Restricted access to formal finance is only one among many of these reasons and it may be contradicted by a variety of other motives.

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[63]This obviously depends on how they estimated the degree of informal finance in the countries in question. If they used the above mentioned method of Tun Wai, then their results could be very inaccurate.

[64]This was conducted against moneylenders in the 1970s. A series of legislative acts condemned them for usury and legitimised their repression, resulting in a very sharp decline of full time moneylenders in the countryside. They were replaced by pawnbrokers or part time moneylenders, many of whom were being financed by the previous full time moneylenders who had taken retreat from centre stage. See Bouman (1989) for an account of this period.

Alternative reasons may be based on straight forward competitiveness, on specialised or adaptable informal services that are deemed superior to formal services, on cultural considerations, or else on the basis of mistrust of formal institutions.

The most commonly cited motive for using informal finance, especially in relation to the collective associations, is the savings motive. People use informal mediation in order to save for three principal reasons. First, their savings may be too small or too awkward for formal firms to handle, such as the shoe shiner saving pennies or housewives saving handfuls of rice. This is the case of segmentation on the savings side. Second, people may desire the collective discipline that compels them to regularly save where they would not on their own. In this case, informal firms are simply better than formal firms at generating collective incentives to save. Finally, people may quite simply prefer informal deposits to formal deposits. Informal assets usually earn more than formal assets, and the impact of one's saving is locally visible since credit relations are personalised.

RoSCAs are the archetypical informal firms for saving since they combine all three of these motives. Since they are collectively organised, they can handle practically any volume agreed upon. Furthermore, awkward deposits are also no problem since the RoSCAs operate with no liquidity (each lot is cleared with each round). Rather, the RoSCA savings are entirely embodied in one's trust for the other participants. Trust also generates a powerful compulsion to carry on contributing once the cycle has begun. Harsh penalties are usually applied to those who contribute late, and banishment to those who default. Finally, once contributed, the savings have an earning potential, and even add a lottery aspect to the returns. In this regard, Bouman points out that since the savings motive is often dominant in RoSCAs, the rotation of one cycle becomes less important than the overall recycled lifetime of the RoSCA, which in some cases can exceed ten to fifteen years (Bouman 1989 55, Bouman 1979 263). Similarly, ReSCAs share many of the same principles as RoSCAs and are also very powerful vehicles for mobilising savings.

The other major motive for participating in informal finance is to have access to credit. Again, this can apply to many situations, from the poor borrower who has no other choice but to call on a moneylender, to the business person who is competitively balancing his or her portfolio. On the lower end of the scale, collective associations and small scale moneylenders are the main vehicles for the average public to access credit. In RoSCAs, people can end out as debtors as well as creditors, and can negotiate lots if their need for credit is great. ReSCAs, village associations, and mobile bankers usually extend credit to members and depositors at preferential rates and therefore encourage membership. Finally, moneylenders and pawnbrokers continue to be popular inconspicuous alternatives to the intrusiveness of both collective informal and regular formal lending. Their credit services are often preferred even at higher interest rates as they are quick, discrete, local, with no bureaucracy or paperwork, and with convenient hours.

Towards the upper end of the income scale, access to informal credit can be just as enticing to those who otherwise have access to formal credit. One of the major reasons is that informal credit is usually quick, no strings attached, and even relatively cheap when implicit costs are considered, all of which can be vital factors in business dealings. RoSCAs and ReSCAs are popular among traders, merchants, and even manufacturers precisely for these reasons, especially since collective membership further increases their ease of obtaining credit. For instance, urban RoSCAs in Nepal have become a largely commercialised system of small enterprise finance, used predominantly by businessmen as an important source of funds for capital formation (SS 185). Similarly, holding an account with a West African mobile banker allows market traders an automatic and daily access to a credit line at competitive rates. Mobile bankers in Benin have been observed to regularly advance from half to four times the total amount of deposits received in the cycle (LG 86).

The credit supply from the larger commercial lenders is also very popular among business people. The Indian finance corporations are appreciated for the flexible and fast credit supply at competitive rates, especially on short term loans. Once a client establishes a credit relationship with a finance corporation, a credit line is guaranteed within certain limits[65], and clients can sanction loans within a day. Loans are rarely refused since

[65] Depositors are usually allowed credit up to 90 per cent of their fixed deposit receipts.

confidence is accorded to the client's overall financial standing. To the contrary, formal banks evaluate the use of each loan, and they may take several days or weeks to process requests (Nayar 1982 23). All of these factors can convince traders and businesses of the competitive advantages of maintaining a regular credit relationship with a finance corporation. The short term credit of the finance corporations complements very well the long term credit of the formal banks, both of which are required by most businesses.

In addition, the Indian indigenous bankers and brokers offer particular advantages in trade credit and may also compete on long term lending in these sectors. Extremely important is the fact that the bankers and brokers do not require trading stocks to be tied up as collateral as required by typical commercial bank lending. Their loans are therefore less cumbersome, which can be crucial in the wholesale trading business. In complement, they are also capable of lending very large amounts to established borrowers, although the larger loans may lose their speed advantage since the bankers and brokers need time to mobilise the funds[66] (TA 56).

Another motive for specifically using collective informal finance is to mobilise for collective ventures. On a smaller scale this can include RoSCAs and ReSCAs organising for bulk purchases at group discounts. On a larger scale, this can include big communal investments in transport vehicles, agricultural machinery, or mills. These investments are the specialty of associative organisations since they have the public authority to keep discipline within large scale ventures. Large scale collective ventures may also include social assistance in times of calamity. For instance, East African village associations may have consolidated their modern eminence during the Italian invasion of the Horn when large scale social security was required by the besieged populace (Gerdes 223).

Collective ventures can also arise out of a desire to manage one's own financial resources. This is definitely the case for poor people who anyways have no access to formal firms, but it can also include the more wealthy who have perceived the merits and profitability of do-it-yourself banking. On an

[66]Exceptions are found in some metropolitan markets, where the bankers or brokers often transact large loans faster and cheaper than equivalent formal lending (TA 54).

individual level, home made banking asks for a full time effort which probably discourages many business people from becoming moneylenders. On the other hand, collective associations ask for only a small amount of time yet offer a high degree of personal input into the management of the collective finances. And the size, not too small and not too big, can make them extremely competitive banking units, perhaps even more profitable than both individual moneylending and formal cooperatives[67]. Profiteers may gloat as a result.

Informal lending is also used as a way of securing risky or competitive markets. Interlinked credit exemplifies this motive. Employers sometime lend in order to secure labour during periods of labour shortage, such as harvesting season (PA 462). Traders lend in order to guarantee the loyalty of clients, or to expand business volume. For instance, merchants often organise promotional RoSCAs to increase their sales, and they regard "the provision of financial services as a necessary cost element in the enterprise" (Bouman 1979 267). Milk collectors in India often finance buffalo purchases by farmers in exchange for a guarantee to supply milk. Mexican trader moneylenders secure through lending the purchase of inputs or the supply of outputs from small scale farmers (GKM 190). West African mobile bankers often lend as a way of protecting their associated cartels from market entry (MMC 719). Across the board, interlinked credit helps to reduce the costs and risk within competitive markets.

Informal credit may also be used as risk capital. For instance, some Indian finance corporations are involved in the cinema industry around Bombay and southern India[68] (Nayar 1982 14). On the other hand, many informal firms disdain risky ventures, such as the Indian indigenous bankers who prefer supplying working capital to established businesses (TA 48).

Finally, informal finance is popular for a variety of extra-economic

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[67]Bouman finds that many Indian ReSCAs do not aspire towards semi-formal or formal status primarily out of managerial concerns. The ReSCAs organisers in question generally feel that a fifty person membership is the ideal balance between size and operational efficiency. In contrast, semi-formal status requires a minimum membership of two hundred, which they feel overloads a collectively run financial operation. They also prefer the operational and political autonomy that informal status offered (Bouman 1989 60).

[68]These and other similar industries are avoided by formal firms given their perilous nature.

motives. Informal methods blend well with a variety of cultural practices. In the Middle East, RoSCAs are popular because they do not defy the Islamic prohibition of charging interest (Van den Akker 1987). The regular meetings of collective associations allow for socialising[69], or for sharing valuable economic information. West African market women often use the meetings to organise their cartels (MMC 718). The collective encounters even allow groups to establish development goals. For instance, the previously mentioned Cameroonian mandjon taxi and transport monopoly emerged out of an objective to create jobs.

Social or political struggles may also form the basis of informality. Many people use the informal organisations as a refuge from the political manipulations of formal cooperatives and banks. Sexual power struggles often occur parallel to this refuge, especially since men invariably dominate the formal institutions. In West Africa, the fact that mobile banking is dominated by financially powerful women while formal finance is dominated by men suggests that the marginalised sexual elite has used informal finance to maintain local influence. In India commodity RoSCAs are often used by women as a way to accumulate savings independent of their husbands. The commodity form of saving allows for a safe subversive way to gain a bit of financial autonomy[70]. Interestingly, the Indian steel pan ReSCA turned informal bank mentioned earlier has a 65 per cent female membership and refuses membership to politically active people (Bouman 1989 64).

In sum, the people using informal finance have many reasons for doing so. Their motives need not resemble an unfulfilled envy of formal finance. In many cases they may be agents of free choice informally compensating what they perceive to be formal deficiencies. In any case, they often have very good reasons for going under the table. And surprisingly, their choice to go informal does not necessarily seem to restrict their money from taking advantage of formal finance.

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[69]For instance, a study of a Nigerian RoSCA calculated the cost of entertainment (food and drink) at three per cent the annual flow of funds (Bouman 1979 262).

[70]A missing handful of rice per day is overlooked by men that flee domestic tasks. The collected rice is converted to monetary savings by selling it in the market.

Where does all that money go

The organisational linkages and flow of funds that informal firms sustain again do not demonstrate any particular tendency towards the financial segmentation of their markets. Segmentation would imply that informal lenders operate out of their own resources, or that informal funds remain within fairly limited and local markets. While this may be the case of an occasional lender, it seems more generally the case that deep and complex linkages permeate most third world financial systems. Informal firms therefore continuously mingle with other informal and formal firms, assuring a complementary flow of resources between all.

Collective informal firms carry on particularly intense linkages with formal firms since they mobilise significant savings over time. Banks may team up with RoSCAs and allow the lots to be used as down payments on loans or on housing mortgages[71]. ReSCAs often find banks and cooperatives to be safe depositories for their accumulated savings, while the latter relish the cheap and easy supply of ReSCA savings that would otherwise be difficult to access. ReSCAs may therefore run their entire financial operations through the formal firms by regularly depositing savings, extending loans through bank cheques, and earning interest on inactive funds (Bouman 1989 60). A study in Nigeria found that on average thirty per cent of ReSCA funds were held as reserves in local banks (Ibe 1990). Correspondingly, organisers of informal collectives often become involved in formal firms in order to strengthen the organisational linkages. Participants take advantage of the linkages to maximise their advantages from both informal and formal firms[72].

Moneylenders and pawnbrokers also attract banks with their regular business volume. Similar to the ReSCAs, they often use formal credit to support their lending activities, hold reserves as formal deposits, and may even lend to formal firms[73]. Formal firms are especially fond of repledging

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[71] Banks involved with this type of mortgage RoSCA have been observed in Bolivia. Lots ranged from five to fifteen thousand US dollars (AC 229).

[72] To take a Bolivian example, RoSCAs are generally preferred for saving while banks are preferred for borrowing (Adams and Canavesi 231).

[73] Lending to formal banks and cooperatives was observed on several occasions in India by Bouman (1989) and in Indonesia by McLeod (1991).

pawns since the pawnbrokers are considered to be secure and profitable clients. In India, although the Reserve Bank forbids repledging, "banks seldom turn away the private moneylender because repledging usually means big business and large loan turnover" (Bouman 1989 82). In exchange for repledging, banks that accept pawns as collateral may subcontract pawn appraisal to the associated pawnbroker (ibid. 83).

As a result, moneylender and pawnbroker portfolios are usually diversified, and the stereotyped vision of the moneylender lending from own resources is seemingly peripheral. Lamberte estimates that Phillipine pawnbrokers source 20 to 30 per cent of their lending capital from formal borrowing and keep 30 per cent of their capital as liquid reserves in a variety of formal assets (Lamberte 1991 235)[74]. A case study of a typical unregistered pawnbroker shop in Sri Lanka found that lending capital was gathered from formal repledging arrangements, from the deposits of business friends, and from the use of overdraft facilities of two banks (BH 83). Many of the part time moneylenders studied by Bouman in India financed their operations through formal borrowing as well (Bouman 1989).

This reveals a more general trend of formal credit wholesaling to individual moneylenders who act as credit retailers. In both dispersed rural markets and sprawling urban markets, it is often more efficient for commercial banks, or even government development banks, to act as wholesalers and to let the moneylenders deal with the nitty gritty of individual client relations. The Mexican agro-industrial enterprises and their associated trader moneylenders have increasingly embodied this symbiosis since the 1970s (GKM 1991). The Mexican enterprises obtain their lending capital from commercial or development banks at often subsidised rates and are therefore able to wholesale at competitive rates. The moneylenders then onlend and trade informally with the associated farmers. Agro-chemical suppliers also use these methods on the input side (GKM 190). Similarly, in the Philippines and Malaysia, schemes using input-output dealers to onlend are becoming common practice among banks and government agencies (Ghate 74).

The larger institutional informal firms develop similar linkages with

[74]Conversely, 70 to 80 per cent of funds are sourced from equity and not from own funds, while 70 per cent of funds are loaned (ibid. 235).

formal firms. Their large volumes, their affluent clientele, and their sophisticated methods all lead naturally to a close collaboration with commercial banks. In some cases, clients use the large informal loans as leverage to access even larger formal loans. This has been observed among finance corporation clients who use their informal borrowing to provide for the margin required on formal loans. "This way, the corporations become instrumental in... expanding the loan portfolio of commercial banks" (Nayar 1982 18). In exchange, commercial banks also often channel funds to informal institutional firms, as observed in India, the ROK, and other Asian countries[75].

Complex informal networks complement the formal linkages. Collective associations are particularly adept in among themselves and they are often conjunctively organised. As previously discussed, rural RoSCAs complement ReSCAs by financing regular fixed investments throughout the year versus the annual ReSCA cycle that is used for harvesting season. In urban areas, RoSCAs and ReSCAs are often organised together, with the RoSCA setting the borrowing limits in the ReSCA and the ReSCA deposits covering for default in the RoSCA (Bouman 1979 266-7).

The collective associations also work with other informal lenders. Both RoSCAs and ReSCAs lend to and borrow from moneylenders, and may even be organised by moneylenders to supply lending capital. They also supply credit information to other local lenders. For instance, RoSCA or ReSCA participation is often used by local moneylenders as a proof of funds or a credit rating. Shared information therefore helps the participant access other sources of informal credit while at the same time reducing the information costs of other informal firms.

Moneylenders are usually linked to a variety of other financial intermediaries as well. Smaller moneylenders borrow funds from larger lenders, or from moneylending associations. Bouman points out that with the repression of moneylenders in India in the 1970s, many of the large lenders retreated into the urban areas and concentrated on financing smaller part time moneylenders in the rural areas or else on lending through urban brokers. These linkages suggest "the existence of a network of informal financiers not

[75]See Nayar (1982, 1986) and Timberg and Aiyar (1984) for India, Cole and Park (1983) for ROK, and Ghate (1988) for Asia generally.

unlike the network of banks" (Bouman 1989 129). Pawnbrokers are also often part of larger networks that provide access to regional pools of funds and in which larger pawnbrokers repledge smaller brokers.

The urban institutional informal firms are again invariably in contact with a large variety of other informal lenders. For instance, Indian finance corporations often work with large ReSCAs or else they organise chit funds[76]. Indian indigenous brokers usually work closely with finance corporations and large moneylenders in addition to the indigenous bankers (TA 47). South Korean informal brokers are heavily involved with a variety of other informal lenders through their curb market activities (CP 119).

Given all of these linkages, the circulation of informal funds seems to know no inhibition. The dollar that a peasant contributes daily to a RoSCA can find itself being onlent to export traders or urban investors, or being deposited in a commercial bank, in another city, or even in another country. Similarly, after having passed through a central bank, down through an indigenous banking association and into the hands of a local moneylender, the same dollar could eventually find itself back into the original RoSCA several cycles later. In other words, segmentation does not seem to be an overriding factor in the informal flow of funds.

In the end, informal finance is more appropriately identified at the market level as one specialised extension of an overall financial system rather than a separate and possibly overlapping "sector". As Bouman (1989) points out, there is "no clear dividing line between formal and informal, as the two are closely intertwined. Funds find their way back and forth between the two markets and go wherever the return is higher". As a result, "linkages seem to develop spontaneously whenever and wherever people perceive such links as advantageous" (Bouman 1989 127). Furthermore, the linkages have existed for centuries and continuously innovate to new economic circumstances. Indeed, formal firms may depend on informal methods more than is generally assumed. The future is far from clear.

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[76]Ninety per cent of registered finance corporations in Bangalore conduct chit funds on a minor scale to supplement main income, while in Madras, chit fund companies use finance corporations to create funds for their chitty (Nayar 1982 9).

Chapter Six; The Real Informal Trends (maybe)

Once the firm and market levels have been assessed, most dualist arguments can be understood as partial interpretations of informality at best. Since most of the macroeconomic impacts discussed earlier are entirely derived from these dualist assumptions, they too can be shown out the back door. The extreme variety and complexity of informal financial structures makes it almost impossible to generalise their impact outside of specific empirical case studies.

What can be discussed is the fact that informal firms do not seem to be transitory, as forewarned by dualism. At least they do not seem so from the hints obtained by looking at informal innovations or their observed growth and popularity. Informal firms appear to have continued to evolve alongside formal finance without necessarily being assimilated by formal systems. They have also maintained their popularity even in the midst of extensive formal financial development in the third world. Case studies that focus on an extended period of informal development are especially enlightening since they do not confirm any necessary trend towards formalisation. In this focus, the suppositions of economic impact must be reconsidered; policy makers may not like informality, but it seems that the people do.

Informal Innovations

Informal financial innovation has been best researched among the collective associations due to their popularity as research subjects and their rapid evolution from simple to complex organisations in the last several decades. Researchers originally considered the scope of these associations to be limited. For instance, RoSCAs rotated within limited and closed groups, and ReSCAs were too short term to be able to accumulate significant long term lending capital over several years. Yet several recent studies conducted over an extended time period point out that both of these associations have not only overcome their earlier limitations, but have also established a longevity that competes with the more permanent formal firms.

RoSCAs have overcome their limitations of closed groups by making their lots negotiable. Bouman found in many recent cases in India that participation in a RoSCA has become the equivalent of equity. More than one "share" can be held by a member, the shares can be traded within and without the RoSCA, and they are often used as collateral or negotiable bills of credit by other informal intermediaries. RoSCA participation is therefore increasingly being used by members to set their borrowing capacity and credit rating. In consequence, the order of rotation in RoSCAs has generally becoming less important than an established and repeated participation (Bouman 1979 269).

In many countries RoSCAs have also adapted to economic instability, such as hyper inflation. Participants respond to inflation by agreeing on indexed contributions, shortening the length of the cycle, decreasing the number of participants, or dealing in hard currency. Naturally, one survey in Bolivia during the late 1980s found that two thirds of RoSCAs were conducted in US dollars (AC 1989).

ReSCAs have been even more apt to innovate since they accumulate and hold capital over time. Bouman (1989) in particular has recorded their evolution throughout the 1980s in Maharashtra, India. In earlier years the ReSCAs were originally used as savings devices with leading activities as auxiliary. Problems arose because the ReSCA cycles were mostly for one year. Funds were therefore cleared each year and each ReSCA would annually have to spend several months accumulating new lending capital. In rural communities where all ReSCAs ran by the same cycle, this became problematic for local non-agricultural businesses relying on the ReSCAs for their regular working capital throughout all parts of the year.

In later years, diversifying economic activity and an increased interest in ReSCA lending stimulated the ReSCAs to innovate their way out of their traditional limitations. One of the major changes was to lengthen and vary the ReSCA cycle. This allowed for the build up and diversification of lending capital, and for longer lending periods with loan durations passing one year, and even lasting the length of a ReSCA cycle. Cycles tended to lengthen to two or more years and to end on different dates. Cycles that reach up to five years are now becoming the prevailing type in many communities (Bouman 1989 60). Some ReSCAs distribute only part of their savings after one year, and continue lending the rest. Others save for a year and then lend for a year or more, distributing only the interest earned from lending activities. Another method reported in 1988 is to collect a large-sized one-time lump-sum payment in the beginning of the cycle to boost working capital for lending purposes and to solve the capital shortage problem once and for all at the beginning of the cycle. The lump sum is organised as a share and is popular in rural areas where money comes all at once (ibid. 67). The previously mentioned steel pan commodity ReSCA turned informal banking institution serves as an excellent example of how far ReSCAs can innovate without ever losing their informality.

As the collective associations become more complex, the organisers often professionalise. In Bolivia, professional women RoSCA organisers may organise six or more at a time (Adams and Canavesi 228). Market women in Viet Nam are known to be highly sophisticated RoSCA organisers. In Nepal, businessmen using RoSCAs as a source of working capital have adopted constitutions and regulations over RoSCA practice. In the ReSCAs studied by Bouman (1989), formalities have tended to increase with complexity[77]. According to his latest news, it is typical for ReSCAs to keep records in passbooks, to use printed forms for loan demands and accountancy, to print regulations, and to require borrowers to produce two co-signers to guarantee loans (Bouman 1989 67). In East Africa, village associations use a significant degree of financial technicality including bank accounts, scriptural payment methods, accounting and management practices, and access to foreign currency markets when emigration is involved (Dupuy 28). In West Africa, the mobile bankers are essentially full time ReSCA organisers that have commercialised the previous collective ventures. Indeed, the West African development from ReSCAs to mobile banking is an excellent example of collectives that become professional and commercial without becoming formal.

The examples of collective informal innovations illustrate the degree to which informal methods can develop without becoming formal. As a result, there does not necessarily seem to be any correlation between the complexity of methods and the formalisation of institutions. Rather, informality often reflects a determined choice of method by participants, and evolves along with their circumstances. This is especially the case of many larger institutional informal firms, such as finance corporations or village associations, since their organisers often derive their expertise from time spent in formal firms.

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[77]The difference should of course be noted between formalities of method, which are used for a better management of larger associations and that can coexist easily with informal credit relations, versus formal institutions.

They therefore tend to be very professionalised, often since their inception.

Popularity and Growth

Informal finance has innovated because it has remained popular in the third world economies. This popularity can again be reflected by the qualitative observations of many case studies. It should of course be noted that most aggregate quantitative measures of the size and growth of informal finance are invariably faulty[78]. Aggregate measures are especially misleading since they can hide the decline of older and less popular forms of informal finance, such as landlord or personal lending, versus the often phenomenal rise of newer forms, such as ReSCAs, mobile bankers, or trader lenders. Qualitative estimates from case studies are therefore the best way of handling these dynamics.

The predominance of collective informal finance, particularly of RoSCAs, has been reported ever since comprehensive household surveys have been conducted in third world countries. For instance, the Ethiopian government Development Plan for 1968-73 estimated the annual savings volume of RoSCAs alone at 8 to 10 per cent of GDP (GKM 43). Around the same period, it was estimated that over 60 per cent of the population in Addis Ababa participated in RoSCAs (Miracle et. al. 710). A 1979 study of Jamaican rural households found that 34.3 per cent of the households surveyed used RoSCAs versus 29.7 per cent that used commercial banks (Huntley and David 142). More recently in Benin, Lelart noted that almost every adult is part of at least one RoSCA, and that RoSCAs absorb approximately one quarter of their income (Lelart 279).

These statistics seem to hold up over time. For instance, the Bank of Korea (south) has conducted triennial surveys since 1967 and found that the proportion of households participating in RoSCAs has remained fairly constant over time at around 65 per cent[79] (Cole and Park 115). Continuous surveys

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[78]See the appendix for a critique of some of the more famous quantitative approaches.

[79]This estimate was taken from a nationwide survey in 1971. In addition it estimated that households contributed up to 32 per cent of their monthly income to the RoSCAs (ibid. 114).

in other Asian or African countries have generated similar results.

Despite the established presence of RoSCAs, the newer forms of informal finance, such as ReSCAs and mobile banking, have been recently overtaking RoSCAs as the dominant form of finance in many third world regions. For instance, Bouman confirms that ReSCAs are one of the fastest growing forms of financial intermediation in India, growing faster than almost all other informal and formal intermediaries (Bouman 1979 and 1989)[80]. In West Africa, ReSCAs were reported in the 1970s to be replacing RoSCAs in market places (MMC 1980). In the 1980s, Lelart reports that mobile banking in Benin has been overtaking both RoSCAs and ReSCAs in the marketplaces (Lelart 1989 288).

To top it all off, associative financial organisations in the Saharan and Sahel regions of Africa may have become the most widespread of all. Dupuy (1990) claims that an extremely high proportion of the West African population adheres to village associations. Recent surveys in the region indicate that 88 per cent of women and 83 per cent of men belong to the associations, with equivalent proportions found among both educated wage earners and among uneducated informal workers or the unemployed. The village associations are so prevalent (and effective) that NGOs have been reported to often bypass formal state channels and deal directly with the associations (Dupuy 25). Similarly in the Horn of Africa it is cited that almost everyone in Addis Ababa belongs to at least one village association (MMC 710).

Commercial informal firms also often experience similar growth and popularity. Pawnbroking is exemplary of this growth. They are currently "mushrooming over Asia with private houses taking most of trade" (Bouman and Houtman 74). Pawnbroking has become so popular in Asia that even formal institutions have embarked on the pawn wagon. For instance, in Indonesia the government monopolises pawnbroking and has managed to be the sole recipient of an average 32 per cent annual increase of pawning volume between 1975 and 1981 (Bouman 1989 74). In countries where pawning has not been made a public cow, private or informal firms usually far outnumber the public firms.

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[80]In his Maharastran study, Bouman (1989) surveyed ten communities in 1984 and found that the ReSCAs outnumbered both formal and semi formal financial firms by about five to one (Bouman 1989 64).

This is the case of Sri Lanka, where private pawnbroking houses are 10 to 20 times more numerous than public offices (Bouman 1989 74). Similarly, a 1986 rural credit survey of Malaysia found informal pawnbroking to be the most important source of lending in Malaysia's rice producing areas, far outnumbering the short term loans of state banks. It further represented 19 per cent of total borrowing in Malaysia, second only after informal shopkeeper-lenders.

The rise of interlinked credit has more specifically replaced the more traditional rural informal credit relations, such as landlord lending or debt bondage, that used to dominate the Latin American and Asian countryside[81]. This substitution in both regions corresponds to the general displacement of landlords by either land reform or by industrial agricultural processes. Traders lenders have especially proliferated with the commercialisation of HYV and related input technologies (GMK 90). For instance in the Philippines, landlord lending supplied 61 per cent of total loan volume in 1950s, 16 per cent in 1978-79, and six per cent in 1981-82 (GKM 112 and Ghate 68). Conversely, input dealers supplied two thirds of all Philippine rural credit by the 1980s (Ghate 81). In Malaysia, shopkeepers, produce dealers, and rice millers provided two thirds of rural credit in the 1980s (ibid. 81).

Finally, the Indian informal commercial firms researched by Nayar (1982, 1986) and Timberg and Aiyar (1984) provide some of the best group estimates of the recent growth of Asian urban informal firms. Since finance corporations and chit fund companies have been registered (although not regulated) since the 1970s, there exist registered statistical records of their size and growth over the last two decades[82]. Both the finance corporations and the chit fund companies are concentrated in the four southern states of India. Their registered growth was so fast that by 1982 the finance corporations alone represented 10 per cent of deposits and 12 per cent of advances lent by commercial banks, both up from under five per cent a decade

[81]For instance, many authors cite that debt bondage has virtually disappeared in India. Ghate nonetheless points out that it may still exist under new forms (Ghate 82).

[82]It must be recognised that these registered statistics represent a minimum estimate since the firms invariably practice under reporting.

earlier (Nayar 1982 28). The registered chit fund subscriptions represented 18.2 per cent of commercial bank deposits in the same year[83] (Nayar 1986 49). In other words, the two combined represented almost 30 per cent of commercial bank deposit and credit in the four Southern Indian states by the early 1980s (ibid. 53). Nayar further points out that the four states are noted for their banking development, with the highest formal credit deposit ratios, the lowest number of persons per bank office, and the highest literacy in the country (ibid. 48). Timberg and Aiyar come up with similar results for the indigenous bankers and brokers. They are estimated to serve a minimum of 30 per cent of urban informal credit markets in India, and possibly more (TA 54)[84].

Similar estimates are found throughout Asia. In 1978 informal credit on South Korean curb markets alone was estimated at 15 per cent of deposits in banks, and more recent estimates confirm this presence (Ghate 66, CP 120). Outstanding deposits and credit with urban informal intermediaries in Thailand during the early 1980s was estimated at 16.7 per cent of total formal deposits and 20.5 per cent of total formal loans (ibid. 66).

If even half of all of these estimates are only approximately true, then informal finance is at worst maintaining a substantial share of third world finance, and at best it is booming. And many of the countries that record such estimates have gone through significant financial and economic development in the last two to three decades, especially in East and South East Asia. In the wake of such a persistent presence of informal finance, its relevance must be reassessed under a new light.

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[83]This data is again probably underestimated since it does not include unregistered chit funds.

[84]Some overlap may exist between the two calculations.

Chapter Seven; An Alternative Interpretation of Informal Finance

Finding the way out of both the trees of detail and the forest of partial assumptions is difficult. An alternative interpretation can nonetheless help to chart a path, as long as it does not fall into the trap of oversimplifying the complex historical dynamics involved in financial informality. This final chapter therefore attempts to redirect attention towards a more historically sensitive interpretation of the issues involved.

If the balance between formal and informal finance is historically contextualised, the monopoly of formal finance in the first world rather than the presence of informal finance in the third may appear to be the transitional phenomena in question. Formalisation has been historically linked to the legal and regulatory hegemony that states maintain over their economies. Yet the opportunities for third world states to hegemonise their formal financial systems have been very different from the first world experience. The precedent set by the first world is therefore limited, and may even be temporary. Consequently, informality may indeed be a lasting feature of third world financial systems. This hypothesis is supported by several political economy perspectives on informality in the social sciences.

Formalisation in the European experience grew out of a specific historical conjuncture combining strong regulatory nation states with colonial wealth. The European states, fuelled by their control of colonial finance and trade, were able to actively sponsor a high degree of regulation and organisation of competitive financial markets. This included an active suppression of informal finance. Formal institutions were therefore established on the fact that they could be coopted into state structures and regulated within national boundaries[85]. Formal firms did not necessarily come to predominance through any competitive substitution of informal firms. Or at least European state activism pre-empted any such historical proof from materialising.

This historical conjuncture has never been paralleled for the third

[85]See the work of Gershenkron (1967) on the interventionist role of European states in both industrial and financial development. See also Jessop (1990) for various political interpretations on the rise of European states.

world national economies. To start with, the economies have often been governed by very different institutional and cultural traditions[86]. In addition, the third world states never had the resources that allowed for the consolidation of their formal institutions[87]. And generally speaking, they never had the degree of state strength and authority as in late 19th and early 20th century Europe.

To add to the dilemma, the contemporary economic climate of third world countries directly discourages increased financial regulation. The fact that third world financial systems have had to adapt to an international environment already established by first world finance has hindered their ability to regulate within a national framework[88]. This has been particularly evident in the conservatism applied to the third world by the international financial community during the debt crisis. Structural adjustment policies generally strive for decreased state interventionism and increased financial openness. Related austerity policies usually cut the bottom out of regulatory budgets. And where partial regulatory policies are applied in this already decaying setting, they usually come combined with a symbiosis of underground activities that are ever more apt to overcome control. The combined effect has been a free for all. In this context, even the most regulated of third world economies, such as South Korea, have had to coexist

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[86]Besides the fact that indigenous economies were very different from European economies, the colonial powers usually applied a double standard to colonial finance. Monopolies would be contained at home while encouraged in the colonies as the best way of exploiting colonial production and trade. This tended to create an excessive concentration in colonial finance that simply would not have been allowed to exist at home. It also established the formal bias against small scale local economies, allowing informal firms to flourish in their absence.

[87]As the wealth of colonial trade and production was largely funnelled through formal banks, that were largely subsidiaries of home banks, the wealth also ended up at home. Following independence, most third world countries remained dependent on this colonial financial system for a while.

[88]While the European states were encouraged to formalise their financial systems due to their heavy debt loads, they were able to do so because their debt was mostly onshore. Third world states must currently deal with even more severe debt loads, yet their debt is mostly offshore. They therefore have little negotiating power against their creditors, and even less power to guide international regulation in function of their needs.

with significant amounts of informal finance. Liberal financial regimes, such as Chile, have fared no better.

Bolstering this trend, informality may be indirectly encouraged by the increased complexity and fluidity of economic structures in both first and third world alike. This can be inferred from institutionalist or post Keynesian perspectives on economic organisation. From the point of view of the state, increased complexity of economic organisation generates a corresponding increase in cost and difficulty of regulating formal institutions[89]. The organisational complexity of the institutions themselves imposes an increasingly high managerial cost of operating formally. Such may be the case of an average commercial banking institution that imposes user costs to cover inflationary expenses. Finally the increased fluidity of economic structures allows for an ever greater ease to side step regulation[90]. As a result of all these factors, the competitive advantages of operating informally may even correlatively grow with the increased economic complexity that accompanies development.

To further support the hypothesis, third world financial informality may anyways be a competitive adaptation of capitalist finance in peripheral regions, as inferred by the structuralist literature on peripheral economies. Given that formal capital tends to concentrate and that formal firms tend to be biased towards large and secure clients, there is a natural rationing that takes place within competitive financial markets. This is especially the case where third world formal financial firms are already oriented towards an international post-colonial economy, thus increasing the disparity between their preferred clients and most of the local population. Indeed, where

[89]The costs of regulation are further heightened by the erosion of the tax base, a side effect of the increasingly evasive economic structures. Many states, such as the United States, seem to have accepted fate and have reduced their regulatory budgets as an austerity response to the eroding tax base.

[90]The ease with which finance can be conducted unofficially has remained an obstacle to formalisation in all countries, as evidenced by the rise of underground finance from the pinnacles of worldly power down to everyone else. Even the IMF, for all of its liberal policies, has been lamenting this fact ever since it realised that the huge errors recorded on their world capital accounts could not be ignored (IMF 1992).

informal firms are linked to formal firms, informality may be the most efficient way for the formal firms to access the capital of the local economy[91]. Informality therefore becomes a competitive adaptation to this form of inverse structural dualism where formal firms are unadapted to local conditions.

Many of these perspectives are captured in the study of productive informality in post-Franco Spain by Benton (1990)[92]. Benton argues that informality is an integral part of the productive (and one might add financial) restructuring and decentralisation that is taking place across the globe in both rich and poor countries alike. He refers to two processes. The first is the restructuring of productive relations between and within countries that has been intensifying since the early 1970s. Restructuring demands a high degree of flexibility and innovation from all economic actors to which informal firms are particularly suited. The second process is the breakdown of the traditional conglomerate industrial model of doing business. This model, privileged by both rich and poor states, considers large scale and formal firms as state of the art, efficient, and developed. Yet Benton argues that it is precisely this model of economic organisation that is proving inflexible and often inefficient in addressing many of the needs for contemporary restructuring. Although Benton refers to formal industrial firms, formal financial firms can plausibly be included in the portrait.

Benton therefore argues that the trends towards productive decentralization in the rich economies and the rise of informality in the poor

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[91]These relations are not new. The British colonial model of finance actively fostered informal finance in the colonies as a convenient way to deal with local indigenous economies that were not perceived as profitable in the eyes of English merchants. This is exemplified by the cooperation between the Chettiar bankers and the British colonial authorities in India and South Asia. From India, the Chettiars followed the British colonial path and financed local economies across Asia while the formal banks, primarily subsidiaries of the British home banks, financed colonial trade and production for export. See Schrader (1992) for an account of this relationship.

[92]Ironically, there is little cross-referencing between the studies of productive and financial informality. Studies of informal finance largely cite the literature of financial development or else of economic anthropologists who specifically study collective organisations such as the RoSCA. Conversely, studies on productive or labour informality rarely cite the literature on financial informality, and usually assume that informal finance is quite simply usurious. Exceptions to this rule are Bouman (1989) and Benton (1990).

economies are both part of a larger global process of industrial restructuring. While all of the traditional social science approaches predicted formality to be a natural and logical extension of developed mass industrial production and marketing, "the experience of recent industrial restructuring compels us to view industrialization as a far more complex and open-ended process than [the classic] approaches implied" (Benton 3). He proposes to reevaluate the "long-prevalent myths about industrialization... [in order] to understand decentralized and unregulated forms of production as elements central to modern capitalism rather than as backward or anomalous behaviour" (ibid. 4). Benton therefore places informality into the limelight of contemporary economic changes, adding that although the direction of these changes is not known, "no superior logic dictates how the profile of industry must evolve. The process will always be contingent on local political, social, and cultural forces that deserve to be placed at the centre of economic analysis" (ibid. 7).

The Benton thesis is a valuable insight for the study of informal finance. For instance, as informal industrial sub-contracting plays an important role in productive decentralisation, informal credit retailing may play the equivalent role in financial decentralisation. In fact, in so far as productive decentralisation takes place informally, it probably relies on informal credit. Many of the younger and rapidly developing forms of informal finance, such as interlinked credit, ReSCAs, mobile banking, or finance corporations, may precisely be adapting to this process.

These arguments add a new twist to the debate on dualism. While it may have been true in the past that many of the appearances of informal finance were related to dual economies, informal finance today may be responding to very different conditions. In other words, informal finance may have quite simply changed.

Conclusion

Academics do not like the unknown, and policy makers do not like bouncing books. They therefore tend to find a causality for every worldly phenomena. Informal finance has fallen victim to this predilection.

Yet informal finance is such a varied and complex phenomena that looking for theoretical causality becomes senseless. Every generalisation of why and how informal finance exists has its counterproof and tends to be limited in time. While some generalisations may have held in certain periods under certain conditions, static generalisations tend to miss the point unless they are considered as historically and empirically relative. The best that can be done is to understand the general operating principles of informal firms, and to remember that they are operating informally for a variety of often contradictory motives. Each informal organisation needs to be understood in its own historical context, specifically in terms of its particular relations and dynamics with other economic actors. While some firms may play a traditional dualist role in their economies, others may have a very innovative and competitive impact. Some firms may disappear, others may develop, some will become formal, and others will come from the formal.

This ambiguity is supported by an overall theoretical and empirical analysis of informal finance. On the firm level, since informal cost structures differ greatly from formal cost structures, any theoretical comparison of formal and informal firm efficiency is indeterminate without a specific empirical grounding. This is confirmed empirically since informal interest rates are generally within a competitive margin of formal rates, especially when transaction costs are considered. Furthermore, informal firms are often much more effective in handling default and extra transaction costs than formal firms given their personalised mode of operating. And informal lending volumes are generally sufficient to meet the credit needs of most local small and medium sized business. All of these factors reinforce the fact that the redundancy or inferior efficiency of informal firms cannot be assumed a priori.

On a market level, the fact that people and funds flow between informal and formal finance questions the assumption that informality exists because of segmented financial markets. In terms of participation, a wide variety of people use informal finance, from poor to rich, for a wide variety of reasons, in a wide variety of sectors. Restricted access to formal funds is not necessarily a reason for use, nor are segmented markets necessarily the object of use. On an organisational level, deep and complex linkages exist between informal and formal firms in most cases. As a result, informal finance does not seem to obstruct financial resource transfers and may even assist such transfers. The argument that informal finance exists due to dualism or segmented financial markets may therefore simply not apply. Rather, it seems that informal firms more likely play a specialised and strategic role within an overall integrated financial system.

On an economic level, it again cannot be a priori assumed that informal finance is any more detrimental to an economy than formal finance. Informal finance may innovate to a great degree without ever losing its basic informality, and may also generate significant opportunities within its related economies. And in the end, informal finance seems to be maintaining its popularity in almost all third world regions despite significant formal financial deepening.

In consequence, there is no reason to generally assume that financial informality is transitory. The standard theories of financial development that insist so are derived from a specific European historical experience that has little relevance for the contemporary context of third world countries. Informal finance might be better understood if considered part of a different historical development of third world financial systems, rather than as a sign of underdeveloped and inferior financial systems.

Indeed, the idealisation of both informal and formal finance is a common occurrence in the study of third world informality. Informality is mostly considered inferior, and formality the opposite. Yet these preordained value judgements do no justice to the understanding of third world financial development. Both informal and formal financial activities can be detrimental or beneficial to third world economies, depending on who is organising the activities, how, where, and why they are being organised.

In recent decades, great efforts have been made by many governments to deepen their formal financial systems and to extend formal servicing to their populations. Advances in many countries have been made to achieve these policy goals, yet often with flagrant side effects and inequalities. Informal finance has often been in check of these developments. In some cases it may have offered alternatives and in others it may have simply reflected the inequalities of society at large, in so far as the privileged usually profit most from both formal and informal finance.

Unfortunately, policymakers are all too ready to trivialise informality as a remnant of a lingering and inefficient past. Rarely is it recognised that informality may have simply become the shadow of modern finance in both the first and third world alike. Better look twice because the shadows are likely to linger far into the future.

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