Financial Landscapes Reconstructed

The Fine Art
of Mapping Development

EDITED BY

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Financial Landscapes Reconstructed

F.J.A. Bouman and Otto Hospes

We chose the landscape metaphor designedly for this collection of readings on financial intermediation. With it we hope to stimulate reflection on all the critical dimensions of financial and quasi-financial services in the processes of development. The metaphor is not only used to indicate the physical features of the financial landscape such as the offices of banks, cooperatives, credit unions, traders, pawnbrokers, self-help groups, NGOs, and whatever other financial or quasi-financial institutions there may be. With the metaphor we wish to emphasize regional diversity and historical change in financial eco-systems. At the same time it stimulates us to explore what relations, norms, actions and processes influence, directly or indirectly, the transactions of savers, borrowers and lenders.

Landscapes

The landscape metaphor leads us to expect variety: lowlands and mountain ranges, broad rivers and little streams, fertile regions, deserts and muddy swamps, urging us to adopt a view on a totality, and to ground the institutions and social processes we study in space and time (Benda-Beckmann 1992). The metaphor points at the planned or spontaneous growth of financial intermediaries and relations as well as their predictable, unforeseen or even unnoticed decline – explaining the ever changing composition of financial eco-systems that do not evolve in one particular direction.

Furthermore, landscapes remind us of the physical infrastructure of a region, with different ways to travel from farm fields to market places, from houses to offices, from village markets to wholesale markets, and of poor roads connecting distant villages with capital cities. This leads one to explore the other interesting avenue of financial landscapes: the connections and disconnections between different kinds of savers, borrowers and lenders. The metaphor directs the attention to "networks" of moneylending traders, money guards, banks and savings clubs, but also to deliberate non-use of financial services and short-circuits between financial intermediaries. For instance, inflation causes people to find refuge in "inflation hedges" in the form of golden necklaces and cattle, while political maneuvers might keep savings clubs and money guards from entrusting even a single penny to a bank. Finally, we should not ignore indirect links, as when agricultural traders partly on-lend their bank loans to farmer-borrowers; or when market women who borrow from a wholesaler, deposit money at a local bank and participate in a savings and credit association, thus connecting different financial flows and intermediaries.

Besides leading us to expect diversity and change in financial eco-systems, the metaphor also brings us to systematically explore their backgrounds, that is, why, how and on what scale changes of landscape take place. The metaphor refers to the complex dynamics of changing ecological conditions and human intervention, that include soil conditions, natural vegetation and crops, but also fertilization, salinization, and deforestation as well as natural phenomena like hurricanes, drought and floods. Diversity of landscapes is a result of different and frequently contradictory efforts at planning by individual and institutional actors who face and adapt themselves to specific ecological conditions and changes.

The metaphor of financial landscapes cautions us right from the start against too easy assumptions about the dynamics of financial intermediaries and relations between borrowers, lenders and savers. The quality and effectiveness of the maps of financial landscapes are very much dependent on the uses one needs them for. We want to distinguish two types of orientation: one that is leading us to a better knowledge and theoretical understanding of what we think the real financial landscapes to be; another that enables the promotion of policies and projects directed at change of financial landscapes or the "cultivation" of financial landscapes (Benda-Beckmann 1992).

Looking at Financial Landscapes

"The landscape metaphor allows us to develop different contextual approaches for the analysis and evaluation of financial services in interlinked processes related to the development of state administrations, markets and communities (Eldijk 1992)." One approach might be to look at evolving social-economic relations between mutually dependent traders and farmer-borrowers (Hendriks, chapter 13), or at moral standards governing lending behavior of village shopkeepers in crisis situations (Southwold-Llewellyn, chapter 15). Another is to evaluate the impact of financial-political maneuvers, such as a change of the central bank's rate of discount and the passing of Moneylenders or Pawnbrokers Acts (Skully, chapter 21) that aim to regulate their number and conduct. But also a sudden increase in money circulation related to changes of consumption standards and increasing transport facilities is relevant because it can bring a financial landscape to erupt (Hospes, chapter 14). Soaring inflation and monetary instability can cause disintegration of the landscape, frustrating the accumulation of domestic funds in banks or self-help groups. Policies that promote the pouring of easy money into thirsty economies are yet another example: they can easily result in the destruction of financial intermediation structures (Seibel, chapter 2) – only increasing the number of graveyards in financial landscapes. Equally significant are measures that inadvertently influence the emergence and retreat of certain intermediaries, such as land reforms causing landlords to withdraw from the sphere of agricultural credit and traders and input suppliers to step in and fill the void (Crow, chapter 16; Hendriks, chapter 13). Many financial self-help groups mirror social-economic changes (Bouman, chapter 22) and demonstrate their enormous adaptive capacities under macro-economic and political-administrative reform.

Official Regulation

There are countries in which the government is viewed as the sole grand designer of the landscape, in which every financial intermediary is licensed and controlled, his actions regulated, and the flow of funds directed towards prescribed sectors, in prescribed quantities to a prescribed number of clients; a landscape in which people deposit their savings with the officially recognized and approved banks. Unregulated curb markets and their representatives are seen as a disturbing factor that should be eliminated.

Conviction becomes reality. The maps drawn by official Indian and Thai statistics are a case in point. They depict a very substantial reduction of the share of informal credit in total cash debts of cultivating households from 70 percent in 1961 to 23 percent in 1981 in India (cf. Jones, chapter 18); in Thailand the share of informal loans has “officially” declined from about 90 percent to 30-50 percent between 1965 and 1991 (cf. Steinwand, chapter 17). These figures suggest that the so-called informal finance sector is rapidly disappearing from the financial landscape. But the landscapes drawn by Jones and Steinwand based on village studies, and supported by our own impressions in Maharashtra (Bouman 1989), show a much more robust and, moreover, positive presence of different informal intermediaries than is suggested by the official surveys and figures.

The official leaning towards discoloring of financial maps is reinforced by the fact that planners and consultants of development agencies persistently ignore the existence of financial curb markets. Even a publication on India’s financial system by an authoritative source like the World Bank (Morriss 1985) does not devote one single paragraph to the subject. Yet, there are very few banks in rural areas in many developing countries, and none in remote locations. But there are many types of moneylenders, traders, pawnbrokers, ROSCAs and ASCRAs (cf. the different chapters in this book).

If we want to explore the rich variety of interrelations between different financial intermediaries, we need to question, however, the analytical value of the dualistic concepts of “formal” and “informal”. These rather clumsy concepts not only violate the empirical diversity of financial intermediaries, they also assume the absence of direct or indirect links between traders, commercial banks, savings clubs, development banks, NGOs, and so forth (Benda-Beckmann 1992).

Market Regulation

There are financial sector specialists, commercial bankers and economists from international development agencies who view the “invisible hand” as the best designer of the landscape. They like to see the financial landscape as one great market, in which every financial intermediary is free to expand his services geographically and to set interest rates that will regulate the supply and demand for capital; a landscape without subsidies that will only ruin financial market places; a landscape in which people are preferably saving in financial assets that can easily be mobilized by commercial banks, subsequently investing their money abroad, in large industrial enterprises and/or in government bonds issued to finance the state deficit, that is, a landscape in which funds flow automatically to rewarding and secure opportunities. Again, informal financial agencies and arrangements are considered a disturbing factor because they reproduce “segmentation of financial markets”, take care only of consumption needs and keep the national economy stagnant.

Unfortunately, the promotion of market mechanisms to structure relations between savers, lenders and borrowers is often based on a one-dimensional map of financial landscapes. Credit transactions and financial services are evaluated in terms of interest rates or transaction costs only, ignoring other stipulations of contracts between borrowers and lenders (contrast Adams, chapter 11) or barriers to credit access (contrast Zander, chapter 12). Credit relations that are embedded in wider social-economic relations are studied in isolation (contrast Hendriks, chapter 13). The rise and decline of different financial intermediaries and specific financial arrangements is not analyzed against the background of location-specific agro-ecological, economic, socio-legal and/or institutional conditions. These dimensions or multiple contexts of financial landscapes are simply left out or assumed to be a constant, in contrast to Abugre, Bouman, Crow, Harriss-White, Hospes and Southwold-Llewellyn, all in this volume.

The use of dualistic or black-white symbols to depict financial landscapes, such as “formal versus informal” and “consumption versus production loans”, allows many bankers to marginalize the development role of “informal lenders”. However, these distinctions are false and misleading. Loans for so-called consumption purposes can be of great importance for income-generating activities (cf. Abugre, chapter 10). Fridges are useful to make and sell ice; radios to listen to news of extension services; bicycles to transport chickens to the market; and medicines to cure the labor force. Not surprisingly, consumption loans do not necessarily represent a greater risk to lending agencies than so-called production loans (Heidhues, chapter 3). Besides, it is rather narrow to consider the use of loans for social security purposes, like housing, education, health and food, as counterproductive for “development”. Likewise, to speak of “segmentation of financial markets” is not only to ignore possible links, either direct or indirect, between financial intermediaries, but also to underestimate the importance for savings clubs, traders, farmers or market women to limit their contacts with banks and cooperatives when the latter impose rigid rules or are simply not dependable.

Multi-Disciplinary Approaches

For a long time it has mainly been economists who have drawn the maps and colored the contours of the financial landscape. However great their skills, this has brought us maps of a very specific signature, now colored with the projections and symbols of liberalism, then of Marxism, then again of neo-classical and new institutional economics. Such maps can only be of limited use. “At the micro-economic level, the McKinnon-Shaw and neo-structural models are mute” warns Fry (1993: 24). The reconstruction of financial landscapes mirroring interlinked developments of state administrations, markets and communities, cannot and should not be the domain of one single discipline. Of necessity, its tools are inadequate to picture the immense variety of the landscape,

Multi-disciplinary approaches are called for to analyze and explain the diversity in forms of financial intermediation and the interrelations existing between them, in regulatory frameworks of financial intermediation, in scale and volume of operations and the variations that occur in time and space. To do that, we need to put finance in context and draw different maps of landscapes at macro and micro level.

Official statistics and estimates become suspect when measured in their true impact. Census data are aggregates, hiding more than they reveal about the underlying contrasts between different sectors of financial intermediation, nor do they do proper justice to the presence and impact of specific intermediaries at different points in history. Only painstaking micro-level research of finance in context, in combination with macro-level surveys, will portray the intricate, rich and vivid details of the landscape. This collection of readings is a mixture of both village and regional studies, using the colorful palette of interdisciplinary painting.

It is beyond this introductory chapter – and indeed beyond this book – to give a historical analysis of the infrastructure of financial landscapes through time and place, while simultaneously putting financial intermediaries and relations in multi-dimensionial contexts of development. But this book does contain a few chapters that summarily record historical particulars of certain financial intermediaries. Skully (chapter 21) analyzes how pawnbroking developed in Asia, and Bouman (chapter 22) discusses the gradual unfolding of different financial self-help groups in Nigeria. Crow (chapter 16) is the more colorful painter of historical landscapes, reviewing changes in rural finance in Bengal since the end of the nineteenth century. Schrader (chapter 20) is the more daring cartographer, going back to medieval times when putting moneylenders and merchant bankers in context in India and Indonesia. McLeod (chapter 6) picks up where Schrader left off, when he describes the evolution of financial policy in Indonesia since independence. Although none of the maps drawn by the respective authors can highlight all critical dimensions of (quasi)financial services in development processes, they all add important details that make our maps of these countries more complete.

Cultivation of Financial Landscapes

Whatever financial landscapes were before, they changed drastically in the twentieth century, more particularly in its second half. Early in this century colonial administrations, greatly impressed by the success of the cooperative movement in the Western hemisphere, began to introduce the cooperative model in the colonies. It marked the beginning of the plight of rural households, and of what Polly Hill (1982: 216) sees as “a colonial obsession with debt”. With the exception of the informal agents, financial intermediaries were – and have always been – reluctant to extend their services to rural areas. Financing rural development was mostly limited to the estate sector; providing financial services to small farmers and other participants of micro-economies was an almost alien concept and was left to export firms working through intermediaries (cf. also Schrader in chapter 20). Such financing could now be left to cooperative savings and credit societies. Setting this cooperative movement on its feet became the self-proclaimed task of colonial authorities.

Progress was slow, and interrupted by two World Wars and the Great Depression. But between the 1950s and 1970s, when the former colonies became independent, rural development became a hot issue among major donor agencies and governments of Third World countries. The All India Rural Credit Survey of 1951 set the tone, when it revealed that over 90 percent of the rural population depended on the services of what since has been called the informal finance sector, while cooperative and government credit together accounted for a meagre seven percent. The resulting political indignation – somewhat hypocritical, considering that earlier Commissions of Enquiry had reported practically the same situation – sparked a long debate on finance and development that has strongly affected the contours of the present-day financial landscapes, not only in India, but worldwide.

The Visible Versus Invisible Hand

McLeod argues that two views on rural finance have dominated academic and political thinking in the post-colonial period. The first is a certain antipathy to informal finance, the second is “the notion that economic development can be encouraged by promoting financial development” (McLeod, chapter 6). This is certainly true, but the issues are rooted in much wider post-colonial debates.

Different battles had a profound influence on the views of financial landscapes. One was a political-ideological battle between adherents of capitalism and Marxist socialism, while some parties championed an intermediate “third way” and promoted cooperatives to structure social and economic life. The other was a battle between economists regarding the effects of official regulation and de-regulation of financial systems, or respectively the Keynesian and the Shaw-McKinnon models of growth. In the first few decades of the post-colonial period, adherents of official control of financial systems dominated policies and projects in the financial landscape, thereby shaping its contours. The cheap credit creed was one of their most dramatic brainchildren.

The Cheap Credit Debate and Its Spin-Offs

The population explosion in the newly independent states, the consequent diminution in the size of farms and gradual pauperization of the rural population, caused a rural exodus of hitherto unknown and frightening proportions that had to be stopped. Development of these countries became now equated with rural development, and this, in turn, with increasing agricultural output and rural incomes of small farmers in particular.

Although the Green Revolution promised bumper harvests, it required the application of costly new technology. According to adepts of neo-marxism, the fruits of the Green Revolution bypassed the small farmers due to their lack of capital, their victimization by moneylenders and traders, and the overwhelming influence of large farmers, landlords and other powerholders, who usurped all potential surpluses. Although often wary of this diagnosis, politicians and planners in developing countries as well as donor agencies agreed that the small farmer should be helped, and the logical remedy seemed to be to provide him with the necessary capital in the form of cheap loans. Since the informal finance sector was obviously the wrong circuit (see McLeod, chapter 6), it became the mission of formal institutions to do this. The financial landscape became dotted with rural banks, cooperatives, and specialized farm credit insitutions, while hundreds of billions of dollars were poured into countless projects that all claimed to have the well-being of the poorer strata of rural society at heart. It was the era of “small is beautiful”, when low-priced small farmer credit became the major tool of rural development.

The cheap credit policy soon largely dominated the reconstruction of financial landscapes, not only in the physical sense through increased numbers of finance institutions, but also through changes in regulations regarding financial intermediation, manipulations by financial authorities, and the domination of research and political and scholarly debate. The world of students and planners of rural development became divided between antagonists and proponents of cheap farm credit, of “financial liberalization” versus what Shaw and McKinnon critically described as “financial repression”. The now dominant views and issues of this debate are described by Seibel (chapter 2): many financial markets have now been deregulated and interest rates are no longer artificially kept low, but allowed to reflect so-called market conditions.

Various other authors, like Crow (chapter 16) and Hospes (chapter 14), do not so much take a position in the cheap credit debate but rather point at its weaknesses, demonstrating that the rate of interest is only one of the many determinants of savings and credit behavior. This brought an increasing number of students of rural sociology, legal anthropology, social geography and development economy to study the actual relations between savers, lenders and borrowers at micro level. Examples of studies of “multiple contracts” are Adams (chapter 11), Zander (chapter 12), Hendriks (chapter 13) and Southwold-Llewellyn (chapter 15) in our book.

The opposition against the cheap credit creed led by Adams and his colleagues of the Ohio State University, however, had also more direct spin-offs. It greatly stimulated studies of financial institutions at local level, and brought a new interest in savings rather than loans and new insights on the sustainability of financial intermediation (cf. Von Pischke and Moll in chapters 4 and 5). It also brought a new understanding and recognition of the importance of the informal finance sector, that was ignored in the models of Shaw and McKinnon (Fry 1993: 18).

The Rich World of Informal Finance

Studies of financial intermediation in the curb market not only emphasized the ubiquity and universality of financial self-help groups (Bouman, chapter 7), but revealed also that the Green Revolution had ushered in new categories of lenders: rich farmers, having themselves profited from the Green Revolution, input suppliers, traders, millers and white- and blue-collar workers with a regular monthly income and access to banks – all acting as part-time moneylender and replacing the former professional moneylender of ill repute. Rural (and urban) financial landscapes in the 1970s and 1980s have thus undergone a major metamorphosis. Pawnshops have become second-hand goods stores selling unredeemed pawns, and financial self-help groups have diversified and grown – some of them handling millions of dollars – taking care of social security, insurance, local and regional investments, and improvement of infrastructure (Bouman, chapter 22). Linkages between these groups and banks have been established and new ones proposed (Seibel, chapter 2). The emphasis has shifted from the rural to the urban scene and from farms to non-farm micro enterprises (cf. Adams and Von Pischke, chapter 9). Now that commercial banks are no longer forced to finance small businesses and farmers, a task for which they are ill-equipped and which left a trail of degenerated financial eco-systems (Von Pischke, chapter 4), others are coming forward to fill the gap. The 1980s and 1990s are becoming the decades of the Non-Governmental Organizations (NGOs).

NGOs: Filling or Falling in a Gap?

A countless number of NGOs have taken up where others have left and continue a policy of cheap credit. In a report for the Conference on NGOs in October 1992 in The Hague, the number of NGOs in India alone is put at several millions! (Ghanshyam Shah 1992: 5). In the Philippines, the number of NGOs has grown to 17,000, while over 12,000 cooperatives were registered between 1987 and 1992 (Ghate, chapter 8). Although most NGOs are indigenous, many are supported by foreign donor parties from all spheres of life, representing a cross-section of society. Many of these donors are NGOs themselves.

During the past two decades, NGO policy has undergone a major shift in emphasis, from welfare and relief orientation to a policy centered on income generation. Provision of financial services for the poor – somewhat misleadingly called credit for micro enterprises – is one of the mainstays of this policy. Sometimes such provision is embedded in what is termed an “integrated development approach”, encompassing “awareness building”, training in all sorts of education that includes “skills”, and health and housing programs. But increasingly, financial services are now provided without such extras and are labelled “minimalist programs”, although technical training and management advice figure prominently in the brochures of quite a number of NGOs. Since most NGO staffs cannot boast of any such skills themselves, these brochures have to be taken with a grain of salt. Although most NGOs profess to aim at long-term viability and sustainability – magic words that are often heard but rarely addressed seriously by NGOs – the sad truth is that almost no organization or NGO could survive without heavy subsidies and grants from sympathetic, but ill-informed donors. The nagging doubt how long the efforts at filling a bottomless pit can last, has been vividly expressed by Abugre, arguing from personal experience that very few NGOs know anything about handling money, having always channeled but not managed funds.

> The concept of the cost of money is still a strange one for many NGOs, including the big ones. Many times one comes across large credit funds managed by entirely unprofessional and untrained staff, the schemes themselves carelessly conceived, designed and implemented, generating an enormous waste and actually leading to either the indebtedness of the poor or their increased dependency on external support (Abugre, chapter 10).

Many NGOs have drawn fresh inspiration from the experience of the Grameen Bank (GB), the arche-type of successful financial intermediation for the poor. One could rightly argue that the success of the GB in Bangladesh has had a devastating effect elsewhere, in the sense that many NGOs have copied and are still trying to replicate the GB model. In the excitement about the GB success, an almost lone jewel in a series of mostly dismal failures, it is easily forgotten that this bank is, indeed, run by professionals, and yet is, after almost two decades of experimenting, still dependent on outside funds to survive. Moreover, replication contains its own dangers of introducing “dormant viruses” and adoption of a model “without a grasp of the substance that animates and sustains it” (Adams and Von Pischke, chapter 9). And, most importantly, the graveyards of public institutions and banks that toiled under the illusion that the poor could effectively be reached with cheap credit projects, have apparently never been visited by most NGOs.[1]

Questions That Mark The Future

Besides concern over the lack of expertise of NGOs in the field of finance, sincere doubts are warranted about the proficiency of banks to alleviate poverty by providing credit to the poor. McLeod is very clear in this respect: “Banks are simply not good at competing for this kind of business. What banks should be doing is simply what they are good at doing” (McLeod, chapter 6). These messages are not new, but are still not accepted by a large part of the international development community, still wrapped up in an ideology that feeds wishful rather than realistic thinking. The question remains what type of institution or agency is most apt to deal with handling financial services to low-income households in both rural and urban areas.

There are those who point out that low-income people in many countries have shown great capability and ingenuity at handling financial services themselves, with a proven potential to adapt to an ever-changing environment (Abugre, Bouman, Jones, Seibel and Steinwand in this volume). Yet another intriguing question remains: is this proof sufficiently convincing for us to abstain from any kind of financial or financial-organizational support? We believe that the answer to this question not only depends on the nature and extent of financial self-regulation, but also on the environment under which financial services are provided. For instance, for communities who recover from environmental, social or political crisis, and for dispersed populations in isolated areas,

> the best option would include: not to inject substantial credit suddenly into rural financial markets, but instead to concentrate on stimulating the environment that stimulates informal savings and credit systems to flourish, pay more attention to physical infrastructure and communication and injecting capital slowly and progressively into the broader economy in general and the informal sectors in particular.” (Abugre, chapter 10)

A differentiated view of contexts can be of great help in better assessing what kind of direct or indirect support is appropriate in what region or situation, but also in deciding when credit supply or linkage-building is not due: “Under conditions of turbulence, it may make more sense not to substantially interfere with informal financial systems that work” (Abugre, chapter 10). In case of ecological crisis, political turmoil, economic decline but also financial and monetary instability, the indigenous systems might be very important devices of low-income people to restrict mobility of scarce financial funds. It would then not be very wise to pursue a development policy directed at integration of financial markets in which the allocation of financial resources is determined by the marginal productivity of capital. This might shift away scarce financial resources of marginalized groups who need and prefer to invest in subsistence security, education and housing (Eldijk 1992).

A contextual approach to the promotion of financial self-help organizations implies a greater emphasis on the creation of an environment that enables them to flourish and shape their own development. With regard to financial and monetary instability, for instance, the organization of finance at the fringes might be best served when at the core of financial systems there is established a competitive banking system placed under the effective control of a properly managed central bank (Eldijk 1992). When banks become dependable institutions that gain people’s trust, linkages between financial self-help groups and nearby banks will evolve automatically. When the local currency is quite stable, participation in ROSCAs and ASCRAs to finance funeral expenses, house construction material or working capital, can be more attractive.

After having witnessed the destruction of financial landscapes through an overkill of credit by international donors, government organizations and NGOs – getting in each other’s way, even competing with each other with too liberal doses of cheap funds – it is time now to study finance in context and to develop policies and projects that mirror region- and location-specific circumstances and grant much more respect to financial self-regulation.

1. Concern over the wild growth and unprofessionalism in the financial landscape created by the NGOs, was involuntarily fueled by experience at the seminar. Of the NGOs invited, a few presented only a brochure that spelled out there activities, but no paper that tried to sum up and appraise their effords at financial intermediation in context. Others were represented by consultants who did present such a paper, of which, unfortunatedly, only two could meet the standard set by the organisation of the Seminar

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2

From Cheap Credit to Easy Money: How to Undermine Rural Finance and Development

Hans Dieter Seibel

Four development decades have passed since the early 1950s. During that period we have become masters in the art of underdevelopment: at the levels of experts, institutions, governments and donors. Underdevelopment in large parts of the world has been expertly prepared, government-made and donor-supported. Of course, there are exceptional cases of successful development. Yet by treating them as such, there is little to be learned from them.

We are now rich in experience and hope to have learned from it – like the proverbial banker who invariably gains from making a loan: either in monetary terms, when the loan is paid back, or in experience, when it is not.

The Modernization Experiment

Inspired by the poverty-alleviating impact of the industrial revolution and, later on, by the effect of the Marshall Plan on the reconstruction of Europe, policy makers and experts during the 1950s and 1960s embarked on the gigantic experiment of technology and capital transfer from the rich to the backward countries of the world.

This task was not left to the technicians. Social scientists constructed a modernization theory and argued that the whole social, economic and financial system of industrial societies was to be transplanted, including values, motivations, educational and legal systems. As a preparatory step, this required a *tabula rasa* strategy, destroying, or ignoring, the obstacles to development embedded in indigenous economies and traditional social systems. As this did not leave much of an entrepreneurial base, the government took it upon itself to act as entrepreneur and banker. The good effects of their deeds were to trickle down to the poor and eventually lead to progress for all segments of the population. On a global level, whatever differences in approach existed, as between capitalism and socialism, Eastern and Western or Northern and Southern cultural systems, they eventually were to converge on a single industrial development model.

The Poverty Hypothesis

A corollary to modernization theory was the vicious-cycle-of-poverty hypothesis, which added to the poor-country approach a corresponding poor-people approach. Eighty to 90 percent of the population in poor countries are poor. They were portrayed as illiterate, improvidential, superstitious, undernourished and of ill health – a mix of facts and fiction. Without further examination, they were assumed to be too poor to save, unable to organize themselves and incapable of self help. According to that theory, countries are poor because people are poor and helpless; and people remain poor as long as their countries are poor.

The two theories are similar in etiology but different in operational approach. Modernization theorists aim at growth and attack poverty at the national or macro-economic level; poverty theorists aim at a dignified life and attack poverty at the individual or micro-entrepreneurial level. There is no abating of the controversy, as indicated by the ongoing Poverty Lending versus Financial Systems approach carried by influential lobbies even into the American Congress (Malhotra 1992).

Cheap Credit and Easy Money

Capital transfer, the poverty hypothesis, the trickle-down effect and government banking all entered into a complex equation, the solution of which was cheap credit. To offset the effects of overtaxing agriculture and to speed up the trickling-down of expected industrial growth effects, governments intervened with subsidized targeted credit. The crucial strategy adopted was credit disbursement rather than savings mobilization. Credit dependency – instead of self-reliance through self-financing – was one of its immediate effects.

When governments took it upon themselves to develop agriculture, they assumed the combined roles of planner, banker, supplier and marketing agency. Among their main financial instruments were interest rate ceilings and subsidies, credit targeting, credit rationing and agricultural price controls. Institutionally, governments fostered specialization, creating separate savings banks, credit institutions, agricultural development banks, etc.

Subsidizing interest rates on loans and directing subsidized credit to priority borrowers and crop-related activities became major development strategies, with agricultural production, rather than rural development, the objective. Institutions were instrumentalized as conduits of government funds, hampering the growth – and sometimes even the emergence – of institutional financial intermediaries and the functioning of rural financial markets. This in turn hindered rural development, including the growth of agricultural production.

As credit was only available for government-imposed and sometimes ill-defined purposes, farmers tended to take advantage of the fungibility of money. They substituted the funds for activities which they would anyway have undertaken or diverted them to other purposes. While this was frequently a rational strategy from the point of view of the farmer, it subverted project additionality. As a result, projects had little or no impact.

Due to inevitable limitations in the availability of subsidies, subsidized lending projects were narrow in scope and void of growth. Given a wide discrepancy between supply and demand for credit and a price (interest rate) far from equilibrium level, credit rationing was one of the principal strategies in credit allocation. Frequently, the wrong recipients obtained the wrong quantities of credit for the wrong objectives. Government officials and experts substituted their own rationality and decisions for those of the farmers and of the market. This led to crop and project failures, sometimes on a large scale. Farmers were practically forced into diversion of funds. Factor allocations were distorted. In some cases, the impact of development projects was negative.

Ceilings on interest rates, usually combined with targeted subsidies, prevented financial institutions from charging interest rates that covered transaction costs. As transaction costs tend to be constant per loan independent of loan size, interest rate ceilings and credit subsidies led to concentrations in the loan portfolio, allocating relatively large loans to a few big farmers, to the exclusion, or neglect, of small farmers and tenants. In addition, the transfer of transaction costs to borrowers (i.e., the non-interest component including transportation costs, legal expenses, opportunity costs and also illicit charges) tended to price small farmers out of the market. Borrower transaction costs also added to the burden of the fortunate few big borrowers, frequently bringing their actual expenses close to what would have been a market rate. As banks acted as conduits of government funds, rather than developing and applying credit policies of their own making, subsidized credit created its own high risks and associated default rates. Undercapitalization and contractions in the lending volume were virtually inevitable concomitants, gradually diminishing the scope and impact of projects. In some cases an inverted interest rate structure, with interest rates on deposits above lending rates, discouraged banking, as practiced for extended periods, e.g., in India, Vietnam and the Philippines.

Subsidized funds were usually channeled through credit institutions specifically created for that purpose. Agricultural development banks and special projects are the most prominent examples. Many of them were barred from deposit mobilization. As a result, institutional facilities for the depositing of savings in organized financial institutions were notably absent in many rural areas. Specialized savings institutions, on the other hand, such as government or post office savings banks, offered negative real rates of return and lacked the sophistication to develop attractive and convenient deposit facilities. In many countries, the rural population created their own informal financial institutions on a self-help basis. Without access to refinance, these were restricted in their capacity for generating the necessary resources for growth.

Subsidized and targeted credit negatively affected loan recovery on several grounds:

1. Farmers tended to consider the loans as free presents attained through government patronage and had no intention to repay;
2. Or they diverted them to other purposes and found themselves unable to repay;
3. Or they complied with ill-founded government directives, invested into activities that were perhaps productive but not profitable due to price controls, and were equally unable to repay;
4. Financial institutions were forced to accept non-bank criteria in credit decisions, perhaps allocating the wrong loan sizes at the wrong time to the wrong customers for the wrong purposes. This inevitably led to high default rates;
5. Because banks were unwilling to take risks not covered by an adequate reserve for bad debts, governments instituted credit guarantee funds or agencies absorbing all or part of the risk. This, in turn, discouraged banks from collecting loans in arrears and further increased defaults.

In many developing countries government interventions, subsidies, loan targeting, reliance on government or foreign rather than domestic funds, misappropriation and diversion of funds, defaulting, price distortions, institutional specialization and a host of related policy and operational factors have been closely related to the underdevelopment of market mechanisms, financial institutions, agriculture and the rural economy. The results of this strategy were succinctly expressed in 1984 in the title of a book by Dale Adams, Douglas Graham and J.D. Von Pischke, *Undermining Rural Development with Cheap Credit.*

In some cases subsidized credit did have positive effects on production, though invariably at high cost.

Estimates are difficult as no country has monitored its costs and benefits. With regard to Indonesia, which until January 1990 ran a number of large subsidized credit programs, the following information may be indicative. From 1978-86, cumulative costs of the KIK/KMKP small enterprise credit project amounted to US$1.58 billion (at current exchange rates) the interest rate equivalent of which is approximately 20 percent (on top of the subsidized interest rate) and ranged, due to its foreign exchange sensitivity, up to 33 percent in 1986 (World Bank 1988). Under the subsidized agricultural credit program BIMAS, Bank Rakyat Indonesia lent a total of Rp.2.55 trillion (US$1.42 billion) over a 14 year period, or Rp.182 billion (US$101 million) per year – at a huge loss. After deregulation in 1983, the same bank introduced its non-subsidized market-rate KUPEDES scheme and lent Rp.5.28 trillion (US$2.94 billion) over a seven year period, or Rp.754 billion (US$420 million) per year – at a profit (all in 1989 prices, converted into US$ at the exchange rate of December 1989). Toward the end of the period, December 1990, BRI financed these loans fully from rural savings (Seibel 1992b: 164).

Repressing the Financial System Through Regulation

Several decades of experimenting with development have taught a powerful lesson: rigid regulation of the economy, in combination with an all-encompassing role of government in all spheres of the economy, leads to underdevelopment. This has stifled the growth of money, production, income and employment.

Production is the motor of the economy, finance is its fuel. Unless there is a functioning fuel injection system, the motor will not run. The faster the motor is to run, the more fuel it needs. It is the financial system which has to pump the money into the economy: it has to mobilize savings, provide credit and assure an adequate growth of the money supply. An undersupply of money will stall the engine, thus halting the economy; an oversupply will lead to inflation, thus choking the engine.

While the government adopted the role of a donor, the banks were unable, or restricted, to act as financial intermediaries between savers and borrowers. The financial system remained repressed, in many cases inoperative. Foreign debts replaced domestic savings.

During the first two development decades, the role of the financial system in economic development was virtually ignored. The theory of the day was modernization through technology transfer with external capital. Domestic capital formation and resource mobilization did not enter into that theory. Well into the 1980s, many developing countries were held in its grip.

Easy Money

The logical consequence from the recognition that cheap credit undermines development appears to lie in the policy recommendation to deregulate and introduce market rates of interest, with the triple objective of mobilizing domestic resources, covering the costs of credit and achieving a balance between demand and supply of money. This raised the question of the definition of market rates. Is there a (single) market rate?

Some countries, among them the Philippines, have introduced what they call market rates for final borrowers. While rates to bank and non-bank (including NGO) intermediaries continue to be subsidized, there is now a tendency to require end-user rates to approximate commercial (sometimes: prime) rates of interest. This is, of course, not the market rate in rural lending, nor can there be a single market rate. The market rate is that rate of interest which covers the costs of funds, administrative costs, risks and an adequate profit margin. For practical purposes, costs of funds may be equated to three-monthly fixed deposit rates. Administrative costs and risks vary widely, depending on type and location of customer, availability of information, services rendered (e.g., doorstep services), collateral, etc. If governments require their banks to lend to farmers or micro-entrepreneurs at undifferentiated commercial rates, they are, in fact, demanding subsidized lending, with the same consequences as any type of subsidized credit.

The second issue concerns the source of loanable funds, whether they are domestically mobilized or supplied by donors and governments. Even when subsidies have been stopped, donors and governments frequently continue liberally to supply liquidity, which discourages banks from mobilizing their own resource base. The rise in interest rates to market level, therefore, does little in dampening the banks' demand for liquidity credit, and there is little evidence that the usual negative consequences of subsidized credit have been alleviated. Based on recent experience of which the Philippines are a case in point, one may thus arrive at the following conclusion:

A policy of easy money represses the financial system just as much as a policy of subsidized credit. The impact on adverse borrower selection, loan apportioning, moral hazard, etc., is hypothesized to be similar to that of subsidized credit. Its worst impact is on the financial system, which it prevents from developing at its own. By increasing the money supply without recourse to domestic resource mobilization, it is also a major factor in budgetary deficits and inflation. When refinanced by international loans it becomes a long-term liability which is not matched by gains in productivity.

Once easy money is available, it becomes difficult for individual banks to escape its attraction. It is too convenient a source of funding. While some bank managers see its limiting effect on the institutional growth of their banks, their board members may be less enlightened. When combined with government credit guarantees, it appears to be a low-risk operation. Banks are lured by governments, and governments by donors, into credit dependency. In that respect there appears to be little, if any, difference between GO and NGO donors.

Market rates alone will not lead to financial systems development. Reconstructing – just as undermining – financial landscapes is most effective when tackled at all systems levels.

Systems Implications

For development to occur it takes more than the experience of underdevelopment. A systematic analysis of underdevelopment, and financial repression in particular, from a systems perspective is therefore but a starting point. There are several systems levels of financial repression.

The Total System

In many countries, the government as banker, entrepreneur, policymaker, planning and executing agency has taken control over the total system. This has resulted in a breakdown of accountability. Regardless of their ideological leaning, governments in many developing countries have implemented central planning – an unexpected form of convergence between socialist and non-socialist countries. As a side effect, this has given powerful individuals in government the opportunity of transferring the wealth of their country abroad – much of this at the expense of later generations.

The Policy Framework

On the policy framework level, regulation or deregulation of respectively, the real and financial sectors are closely interrelated. Through prices and quotas, government takes control over exports and imports of real sector goods. Overvalued domestic currencies make imports cheap, including technology. As a free flow of imports is unaffordable, government has to resort to rationing. This leads to under-the-table trading of import licenses. Import substitution becomes the guiding principle of industrial policy, rather than export promotion of finished products. Agricultural prices are controlled, to the advantage of the urban wage earners. Much of the proceeds of agriculture is taxed away directly to finance the government budget and indirectly to stimulate industrialization. Low prices, however, discourage the farmers from producing food and cash crops. This is then partially offset by food imports at subsidized prices, which further distorts local agricultural markets.

The Legal and Regulatory Framework

The banking law has been a powerful instrument in suppressing financial growth. Here are some of its tenets:

1. All power to the government, none to the central bank;
2. Nationalize all banks;
3. No foreign banks, no joint ventures, which bring in alien influence;
4. Allocate the turf, eliminate competition;
5. Prohibit branching out;
6. Restrict the services of each bank, eliminate universal banking;
7. Restrict deposit mobilization to a few institutions;
8. Define collateral requirements narrowly, which may exclude up to 90 percent of the population from borrowing;
9. When the financial system turns terminally ill, concentrate on curing the symptoms, e.g. using targeted subsidized credit as one of the remedies.

Institutional Infrastructure

Given the overregulation of the financial system, many governments regarded it as superfluous to impose further bank supervision through differentiated supervisory institutions. A repressed financial system does not require a differentiated institutional infrastructure. The primary objective of this infrastructure is to serve the purposes of the government as defined in the development plan. A banking industry with its own separate business interests is not to be tolerated. It appears as if guidelines had been issued for suppressing the growth of the financial infrastructure including the following:

1. No differentiated financial infrastructure and branch network required to intermediate between savers and borrowers;
2. No village banks;
3. No banks for the urban informal sector which has no collateral and is an undesirable industrial element;
4. Let every ministry and government agency run its own credit program, with its own rules, terms and philosophy;
5. Let specialized institutions handle financial transactions on behalf of government, comprising government savings banks as a source of revenue (to be invested in low-yielding treasury bills, which in turn requires low interest rates on savings); development banks as credit supply institutions disbursing the revenue; plus a few commercial banks for the formal sector.

Financial Products, Procedures, Terms and Conditions

Under conditions of repressive finance, banks are required to follow administrative procedures set by government. Banks do not learn from each other or from experience, nor is there any learning from local or informal financial institutions. Loans are uniformly allocated according to defined production goals, which leaves little room for loan appraisal or creditworthiness examination. Administrative delays in credit delivery have no impact on lending decisions. There is minimal, if any, monitoring, and loan collection is passive, with no recourse to social controls, enforcement of repayment or litigation. No efforts are made to actively collect savings.

Loan terms such as sizes, maturities and grace periods are not individually determined. They are also undifferentiated within a series of repeat loans. In production credit, collateral requirements are usually waived. Installments tend to be in long, with quarterly or seasonal intervals, ignoring individual repayment capacities deriving from other sources of income. Loans are generously rescheduled, and new loans granted before the old ones are repaid. Penalties are not enforced, nor are there incentives for timely repayment. At election time repayment may be waived altogether.

Target Groups and Beneficiaries

The world of credit-driven, supply-leading finance and social banking uses its own language, displaying a predilection for beneficiaries and target groups of channeling institutions, handling banks or conduits. In contrast, there is the savings-driven world of demand-leading finance and competitive financial intermediation with its own language: there are savers and deposit takers, lenders and borrowers, customers or clients and banks. In fact, the customers or saver-borrowers may own financial institutions, as in the case of cooperative banks.

A Systems Approach to Micro-Finance

Subsidized targeted credit for beneficiaries defined by government undermines institutional viability and systems sustainability – this is the principal lesson of the past. But how can effective financial services for all segments of the population be attained, together with institutional viability and systems sustainability?

Micro-entrepreneurs and the poor have not benefitted from financial repression. In fact they have paid most of its price. It is now being realized that a full range of financial services to micro-entrepreneurs and the poor as well as all other sections of the population depends foremost on the quality and effectiveness of financial intermediaries, and their viability in turn depends on the sustained health and growth of the overall financial system.

A financial system comprises a number of subsystems as discussed above which may be combined into the policy environment, the institutional environment and the instrumental environment – each open to external influence and intervention.

The optimal provision of financial services will ultimately depend on the successful development and integration of all levels of the financial system. However, from a systems perspective, this cannot be accomplished overnight and all at once as suggested by McKinnon (1973) and only much later revoked (cf. McKinnon 1988; 1992). In actual practice decisions are required on ground rules for interventions and strategic entry points.

Process Ground Rules

The landscape of finance is not adequately captured by the concept of the structure of the financial sector, which has been the object of most financial sector studies in the past. It now appears that a static concept of structures and component parts only befits a situation in which governments, rather than markets, possess the power of resource allocation, with a tendency to administrative definition of financial contracts and structural frameworks, as is in fact the case in many developing countries. From a strategic viewpoint, governments in these countries have shielded the structure of the financial sector from external influences, preventing adaptation and creating an artificial stability in a world of flux and turmoil.

Those developing countries which have undergone a process of gradual and prudential deregulation and have submitted their financial institutions to market forces require a new conceptual approach to finance: an approach which emphasizes process rather than structure, dynamic rather than static interrelations, interactive rather than prescriptive decision-making. In a systems approach, the world of finance is envisaged as a complex open system in which the component subsystems are dynamically interrelated, with a change in one resulting in a change in all others, yet a stable equilibrium remaining an elusive state, and with satisficing rather than optimal problem solutions. From a strategic viewpoint, governments in these countries have typically exposed the financial system to external influences from within and without, thus contributing to continuous adjustments on local, national and global levels.

It is therefore not feasible to arrive at an identifiable optimal financial system, and even less so at a single definite set of steps of transition. Instead, there may be process ground rules that have to be observed for interventions to have a chance of market acceptance and success:

1. Any intervention can only depart from the state of the system as a whole at a given point in time. This also includes the cultural, social and political set-up, to which interventions have to be properly adjusted;
2. The acceptance of interventions depends on interactive rather than prescriptive approaches;
3. In a complex interrelated system, all interventions have unintended results. Careful impact monitoring is therefore necessary, which must not lose sight of other subsystems and secondary effects;
4. Interventions will at best lead to satisficing, not optimal results;
5. In evaluating the results of interventions, it is more important to envisage the overall process of change initiated than narrowly focusing on performance criteria;
6. Interventions can only succeed with the market, not against the market. This also means that the market, not the government or donor, decides over its acceptance.

Financial Infrastructure Development

In the field of micro-finance, appropriate strategies for financial infrastructure development (see Table 1) may offer entry points for strategic interventions, with a particular emphasis on local financial institutions, member-based or community-based. At least four different strategies may be discerned: (1) adapting formal financial institutions to the local environment (downgrading), (2) upgrading informal or semi-formal financial institutions, (3) linking formal and informal financial institutions, and (4) creating new institutions (infrastructural innovation).
None of these strategies is universally applicable, nor does any single one offer an optimal approach. Their appropriateness depends on local circumstances and conditions, which need to be carefully assessed. Some of these conditions, and examples, are shown in Table 1.

In a subsequent stage of intervention, infrastructural development may be followed by measures on the levels of financial product innovations, procedures and terms and conditions (cf. Seibel 1991; 1992a). This also requires coordination with measures of financial infrastructure development.

Many of the institutions that may provide the strategic entry point for interventions require institution-building and capacity-enhancing inputs which they are not able to finance from their own profits. Furthermore, if a new infrastructure is to be developed at the grassroots or village level, which may be necessary in many developing countries, considerable financial infrastructure investments are required which may not immediately pay off. Institution-building may thus become a major field for subsidies. Financial subsidies undermine micro-finance, but institutional subsidies may contribute to the development of a micro-financial infrastructure.

A friendly policy environment will greatly facilitate such an approach. In a less than friendly or hostile environment, two supportive strategies may be examined: (1) niche-seeking in the short run, and (2) supported by a joint donor effort, policy reform in the medium or long run. Experience from Indonesia before deregulation shows that even within an inappropriate policy environment viable financial services can be feasible at the grassroots level. Examples are BKK in Central Java and LPN in West-Sumatra (Malhotra 1992; Seibel 1989).

Table 1: Appropriate Strategies of Institutional Development

Strategy	*Conditions*	*Examples*
Adapting formal financial institutions to the rural/informal sector environment (downgrading)	Effective formal institutions exist	BRI[a] (Indonesia), BDB[b] (Indonesia), BAAC[c] (Thailand), NMDB[d] (Philippines)
Upgrading informal financial institutions	Effective informal institutions exist	Bank MBM[e] (Indonesia), numerous NGOs
Upgrading semi-formal financial institutions	Effective semi-formal institutions exist	Cooperative or NGO banks
Linking formal and informal financial institutions	Both effective formal and informal institutions exist	Linkage banking projects in APRACA member countries
Creating new institutions	Absence of effective formal or informal institutions	Grameen Bank[f] (Bangladesh), VBA[g] and share-holding banks (Vietnam)

[a] Bank Rakyat Indonesia: the largest rural-agricultural bank in Indonesia, government-owned but operating as a commercial bank.
[b] Bank Dagang Bali: a privately owned commercial bank in Indonesia.
[c] Bank for Agriculture and Agricultural Cooperatives: a government-owned agricultural bank.
[d] Northern Mindanao Development Bank: a private thrift bank.
[e] Bank Maha Bogha Marga: the first bank set up by an NGO in Indonesia.
[f] A self-help group-based bank, mixed ownership.
[g] Vietnam Bank for Agriculture: a government-owned agricultural bank.

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3

Consumption Credit in Rural Financial Market Development

Franz Heidhues[1]

During the 1980s, there has been a fundamental shift from a supply-leading to a demand-oriented approach to the development of rural financial markets in developing countries. Dale Adams (1984) and his colleagues at Ohio State University provided increasingly persuasive evidence that the supply-leading approach to agricultural credit has failed. This approach was based on the assumption that the savings potential and the supply of finance in rural areas was insufficient for setting development in motion. Therefore, it was suggested to inject cheap funds from government and external sources into rural areas, regularly targeted at specified groups for predetermined productive purposes (investments, fertilizer, seeds, feed, etc.). Specialized, often state-owned agricultural banks, were established with the sole purpose of channelling production credit to a limited clientele. With many of these financial institutions failing, attention has shifted to building financial markets based on rural clients' demand.

The rationale of providing credit for production purposes was simple: credit, used to enhance the productive capacity of the borrower, will increase his future income, which, in turn, will allow him to pay interest and repay the loan. The actual performance of agricultural credit programs in many developing countries, particularly in Sub-Saharan Africa, seems to suggest that borrowers failed to follow this rationale on both accounts: the economic efficiency of credit use has often been low; the repayment performance has been poor. Many agricultural lending institutions operated with losses, and some collapsed when governments became unable to sustain them financially.

Cheap credit policies, often implying negative real interest rates, have been seen to be an important contributor to institutional collapse (Adams 1984). Low interest rates make it difficult for commercial banks to mobilize savings. They tend to lower the margin on lending, causing banks to ration credit to a few and generally the larger and wealthier borrowers. Market determined interest rates are likely to reduce the lending bias towards large borrowers and to support the availability of credit for consumption purposes.

The central argument of this chapter is that limiting credit to productive purposes is not only futile because of the fungibility of financial resources, but that it is also inappropriate and even counterproductive in the endeavor to build sustainable rural financial institutions. Providing production credit is only one of the three needs financial markets must address at the micro level. Failure to address the other needs will hamper financial market development.

The chapter first discusses the functions financial markets have for rural households and then shortly addresses the difficulties in separating consumption and investment expenditure in rural households. Thereafter, a brief review of rural households' needs for financial services follows. Based on surveys in Cameroon and Benin it will be shown that consumption purposes play an important or even dominant role in credit demand. Besides loan services, rural households show strong preferences for savings opportunities. It is also apparent that rural households look at financial markets as providing important insurance functions.

Based on the field surveys in Benin and Cameroon and taking into account experiences of other innovative credit schemes with consumption credit components, we will try to show that credit programs with consumption credit orientation are performing well in terms of target group orientation and outreach and show better or at least not worse repayment results than traditional production oriented credit programs.

Functions of Financial Markets

Financial markets serve three important functions for rural households/farms. All three functions can principally be served by formal as well as informal institutions (Schmidt, Kropp and Weires 1987). Figure 1 illustrates these functions:

1. I am indebted and grateful to Gertrud Schrieder and Brigitte Hofmann who carried out the financial market and household surveys in Cameroon and Benin, respectively, on which the paper draws heavily.

Figure 1: Functions of Financial Markets

Income generation and/or increase	Income and consumption stabilization	Income security; insurance
◊ through	◊ through	◊ through
Investment and production credit	Savings/dissavings and consumption credit	Provision of potential access to financial resources

Production Credit

Production credit is extended for the purpose of increasing the borrower's production capacity and income. This function has been the center of attention in literature and research on financial market development. I will not elaborate on this function, but want to emphasize that in too many countries this approach has failed, measured by three dominant development objectives: promoting growth, improving distribution and strengthening institutions. Too often, it has been found, agricultural production did not expand and loans were not repaid. Also, only a small segment of the rural population was reached and the institutions providing such loans became increasingly weak and some even collapsed under the burden of loan defaults. It seems that the failure of production credit and the faltering of rural formal financial institutions are inversely related to the income level of a country. We observe rural bank failures particularly in the poor countries of Sub-Saharan Africa. This may simply be explained by the fact that the poorer countries are not able to subsidize unprofitable financial institutions for any extended period. It may, however, also reflect the rural population's relatively greater need, in poor countries, for the other services of financial markets, i.e. consumption credit, savings, and insurance. In not responding to these demands, production-oriented credit institutions cover only a small section of the demand spectrum and have no chance of building a broader based clientele in rural areas.

Consumption Credit

Consumption credit is an important component of financial needs of rural households. In Figure 1 the roles of rural financial markets in consumption stabilization are shown as being pursued by two possible strategies: the savings/dissavings process and consumption credit. Both are connected. If the food security[2] of a household is at risk, various strategies may be chosen. In a situation of temporary food insecurity, entailing a short-term temporary shortfall of consumption below the needed level, households may diversify their income sources, sell assets or ask for support by others. However, they may also resort to informal and formal suppliers of credit and savings services. Typically, the closer a household is, even in a "normal situation", to inadequate food consumption level, the greater the need for access to any of the food securing strategies; and the more limited the income diversification, asset sale and inter-household support strategies become, the more important will be the access to rural financial intermediaries and their services.

If a transitory food insecurity occurs repeatedly, the production and income base tends to get eroded, and the household may finally face a chronic food insecurity. Timely access to suppliers of credit and savings facilities may help prevent the occurrence of a chronic food security problem for a household.

Insurance Through Potential Access to Suppliers of Credit

The third function of financial markets is to improve a household's ability to cope with potential risk situations. In contrast to the first two functions, the immediate goal is not to directly influence income or consumption in a particular period, but to increase the range of options a household has at its disposal to cope with periods of income or consumption stress.

Sources of risk in rural households are manifold, and the timing and intensity of risks and its impact on income are difficult to predict by households. Formal insurance schemes are often not accessible to the rural population. Households, thus, pursue a range of strategies of self insurance: they save in the form of cash, deposits, food or other assets; they diversify production structure, cropping patterns and income sources; and they build networks of social relationships. However, in intense and extended risk situations, and particularly in the case of covariate risks, the self-insurance mechanisms may not be sufficient. The mere access to credit,

2. Food security, at the household level, is defined in its most basic form as access by all household members at all times to the food needed for a healthy life (J. von Braun, H. Bouis, S. Kumar, R. Pandya-Lorch 1992).

not the actual borrowing, can serve as an important insurance substitute. Having potential access to credit enables the household to transfer part of its risk to the financial market.

Lacking access to formal finance and insurance schemes, rural households resort to indigenous informal savings and credit arrangements. Studies of African and Asian informal financial markets point out the variety of savings and credit options that these sources provide, but indicate also the insurance, co-insurance and risk pooling services these markets provide.

Ensuring potential future access to credit in an informal market requires, as the most vital element, the building of trust, reliability and confidence within the local community. It will be shown below that rural households in their participation in informal financial markets appear to be well aware of this need.

Production Linked to Consumption at Household Level

The integrated nature of production and consumption activities in rural households has been one of the fundamental reasons for developing the farming systems concept. Ruthenberg applied the traditional approach of continental European farm management theory to farms in developing countries. He saw rural farm households as a complex interlinked system of production and household activities, characterized by the common use of labor, land and capital (Ruthenberg 1980).

In this system, consumption activities are inseparably linked to the production sphere and vice versa. Expenditures for food, health and education are needed to maintain the most important production factor: labor. Social activities may serve to build a mutual support system. In the farming systems literature these interlinkages have been amply researched and documented, and development projects take this increasingly into account in their approach. This cannot be equally said for the rural financial market literature and even less for rural financial market policy, where the “agricultural credit” project syndrome still prevails over “rural financial market” development. The failure to recognize these facts and to open the supply of financial services to all needs of rural households, hampers rural financial market development. It leads to approaches and programs that bypass important, and in emergency situations often the most important, needs of rural households. In that way a large part of the rural clientele is alienated, particularly women and the poor.

Financial Market Surveys from Cameroon and Benin

In a survey covering 160 rural households in the three Cameroonian provinces Adamawa, North West and West carried out between August 1991 and September 1992, 441 individuals were asked about their credit and savings activities. Slightly more than half (226) of the people interviewed lived in villages with a credit union office and thus could turn at low cost to a formal financial institution. Yet, only seven respondents took out a credit union loan compared to 146 taking a loan from a financial self-help group. 215 respondents lived in villages without such locally-based formal institution; to apply for a formal loan they had to travel significantly longer distances to neighboring villages or towns. The Cameroon study was divided into three survey rounds (recall periods). The first survey round was between November 1991 and January 1992 (recall period: September 1990 until September 1991). The second round took place in April/May 1992 (recall period: dry season), and the third in September/October 1992 (recall period: rainy season). For this paper, data of the first survey round were analyzed. Therefore, all results are preliminary. The survey in Benin, carried out in 1989 in the Southeast province of Oueme, covered 143 individuals in 80 rural households in four villages. Other than the government institution (CARDER) there was no formal source of funds.

Consumption Credit in Cameroon and Benin

Table 1 indicates that in Cameroon the overall amount of credit and gifts was almost evenly divided between production and consumption.[3] Rural people’s use of consumption credit was, however, much wider, as individual consumption loans were smaller (US$135 on average) and the number of these loans was more than three times the number of production loans. Consumption credit, especially from informal sources, was taken primarily to cover health, school, and food expenses (see Table 2). The main sources of both production and consumption loans were informal groups and individuals. The presence of a formal finance institution appeared to have little impact on the number of clients reached; however, they contributed about half to the total loan amount extended.

3. A loan was categorized as consumption loan when the percentage share of it spent for food, health, education, and social events exceeded the amount spent for production purposes. Similarly, a loan was considered a production loan when monies spent on agricultural/livestock/handicraft equipments and inputs, labor, and capital investments such as housing, exceeded the percentage share spent for consumption purposes.

Table 1: Cameroon: Borrowing by Purpose and Source in Eight Villages (in Frs 1000 CFA)

	Productive Purposes[a]			Consumptive Purposes[b]			Total
	N	Mean	%Share	N	Mean	% Share	in %
Formal institutions							
- Banks	1	3,000	99	1	100	1	100
- Credit unions	1	100	23	6	55	77	100
- Projects	10	140	99	1	8	1	100
Informal institutions							
- Financial self-help groups	21	38	20	125	25	80	100
Individuals[c]	21	38	38	72	18	62	100
All in % of purpose			56			44	100

Notes: The data correspond to the recall period September 1990 until September 1991; in kind loans are included here with their cash value; exchange rate: US$1 = FCFA 268; the gift economy contributes additional 38.6 percent to productive and 69.8 percent to consumptive purposes in amount received.

[a] Productive purposes include production inputs and capital investments.

[b] Consumptive purposes include food, education, health, and other miscellaneous expenses.

[c] Individuals refer to: close relatives (57 percent); friends (32 percent); distant relatives (10 percent); traders (1 percent).

Source: Schrieder, Heidhues, University of Hohenheim: Cameroon, Rural Credit Study 1991-92.

Considering the type of funds used for the various purposes, the more or less subsidized loans from banks and development projects were used almost exclusively for production, while credit unions, informal groups and individuals financed predominantly consumption purposes. Gifts (from relatives and friends) were partly used for production, but mostly for education. Noteworthy is also the size of the “gift economy”. The gift economy in Benin accounted for more than 39 percent of all funds transferred (Table 3). In the Cameroon survey, gifts added up to almost 33 percent of all funds households received. They play a most important role in financing consumption expenditures, particularly education (Tables 4 and 5) but are also significant in production.

In Benin (Table 3) production credit accounts for only 24 percent of total loan amount and 18 percent of the number of loans received by the rural households. It should be noted that the formal national agricultural credit

Table 2: Cameroon: Use of Formal and Informal Loans

	Informal Sources (N= 223)		Formal Sources (N= 20)	
	Mean share of single loan used for ... of total amount borrowed (in %)	Average amount used for ... (in Frs CFA)	Mean share of single loan used for ... of total amount borrowed (in %)	Average amount used for ... (in Frs CFA)
Food	18.94	2,513.1	7.11	1,736.8
Health	25.35	4,665.7	6.05	4,013.2
Social events	9.88	2,364.0	2.63	2,235.1
School expenses	22.92	6,402.6	20.79	14,736.1
Farm implements and livestock	2.28	1,687.0	58.95	231,888.2
Farm inputs	6.95	865.8	0.26	664.5
Handicraft and trade	8.61	4,130.3	4.21	4,210.5
House construction	2.76	1,200.0	0.00	0.0
Tax payments	0.38	249.0	0.00	0.0
Other uses	1.92	163.5	0.00	0.0
Total[a]	99.99		100.00	

Notes: The data correspond to the recall period September 1990 until September 1991.

[a] Numbers may not add to 100 percent because of rounding.

Source: Schrieder, University of Hohenheim: Cameroon, Rural Credit Study 1991-92.

Table 3: Benin: Borrowing by Purpose and Source (in Frs 1000 CFA) and Repayment Rates

	Productive Purposes[a]			Consumptive Purposes[b]			Total
	N	Mean	%Share	N	Mean	% Share	in %
Formal institutions							
- Credit project/CARDER	5	7.3	100	-	-	-	100
Informal institutions							
- Financial self-help groups	8	8.8	28	16	11.4	72	100
Individuals							
- Traders	11	2.3	9	9	27.7	91	100
- Friends and relatives	15	6.1	25	157	1.8	75	100
All in % of purpose			24			76	100
Repayment rates							
- Formal financial sector	80	86		-	-		
- Informal financial sector	93	97		92	90		
- Overall	91	95		92	90		

Notes: In kind loans are included here with their cash value; exchange rate: US$1 = FCFA 268); the gift economy contributes additional 39.2 percent to the total amount received; gifts in cash account for 43 percent and gifts in kind for 57 percent respectively.

[a] Productive purposes include production inputs and capital investments.

[b] Consumptive purposes include food, education, health, and other miscellaneous expenses.

Source: Hoffmann, Heidhues, University of Hohenheim: Benin, Rural Credit Study 1991-92.

organization CNCA (Caisse Nationale de Crédit Agricole) with its regional (CRCAMs) and local branches (CLCAMs) had stopped extending credits. Consumption credit played a dominant role in loan transactions of traders, financial self-help groups as well as friends and relatives.

It is well documented that informal groups are important in rural financial markets in Sub-Saharan Africa (Bouman, this book; Seibel and Marx 1987; Heidhues and Weinschenck 1989; Bédard 1991). The surveys from Cameroon and Benin confirm the general picture. In Cameroon, in villages with no formal institution, 93 percent of interest bearing and interest free loans were taken from informal financial groups (called *Njanggis* or *Tontines*).

Insurance Function

As pointed out above, rural households can cope with specific risk situations through borrowing and savings transactions. Particularly in rural areas where possibilities of formal insurance, such as health, crop or animal insurance, practically do not exist, financial markets can fulfill that role (Baker and Bhargava 1983).

To assess the role of financial markets as viewed by rural households, members were asked for what main

Table 4: Cameroon: Use of External Funds by Type and Purpose in Village WITH Formal Financial Institutions (in Percentage of Number of Transactions)

	Production	Capital Investment[a]	Education	Food	Others	Total
Loans with interest	16	34	9	41	-	100
Interest-free loans	26	23	33	18	-	100
Gifts	6	78	4	3	-	100
Total	16	24	35	25	-	100

Notes: The data correspond to the recall period September 1990 until September 1991. Four of the eight villages included in the household survey had a local credit union, and were thus classified as villages with a formal financial institution. Use of external funds reported in 126 from 226 cases.

[a] Capital investment refers mainly to housing.

Source: Schrieder, Heidhues, University of Hohenheim: Cameroon, Rural Credit Survey 1992.

Table 5: Cameroon: Use of External Funds by Type and Purpose in Villages WITHOUT Formal Financial Institutions (in Percentage of Number of Transactions)

	Production	Capital Investment[a]	Education	Food	Others	Total
Loans with interest	24	30	10	34	2	100
Interest-free loans	16	13	53	16	2	100
Gifts	30	13	53	4	-	100
Total	23	22	31	22	2	100

Notes: The data correspond to the recall period September 1990 until September 1991. Four of the eight villages included in the household survey did not have a local credit union, and were thus classified as villages without a formal financial institution. Use of external funds reported in 139 from 215 cases.

[a] Capital investment refers mainly to housing.

Source: Schrieder, Heidhues, University of Hohenheim: Cameroon, Rural Credit Survey 1992.

reasons they turned to individuals or particular institutions for funds. Out of a total of 117 funds received from individuals, 77 percent had taken them because they had confidence in that person and were willing to return the received help if the other was in need. Low cost or non availability of alternative sources played a much lesser role. It is apparent that mutual aid and the possibility to get support in emergencies is a dominant motive in individual credit transactions.

Confidence and mutual aid play an important role for seeking funds from credit unions and, as would be expected, from *Njanggis/Tontines* and other mutual aid groups. Lack of alternative sources, as well as low cost and confidence, were the reasons to turn to project credits. While the responses are difficult to interpret without further analysis, it does indicate that in building financial market institutions, confidence and trust in the accessibility of a financial source in case of need seems to play an important role.

Repayment Performance

The rationale behind production credit stems from the fear that credit for consumption purposes will not generate additional income out of which the loans can be repaid. However, preliminary results of data from the Cameroon survey indicate that other factors seem to play a more important role in repayment performance. In fact, consumption loans have a slightly better repayment record. Of 124 interest bearing loans analyzed, with amortization and interest due during the recall period, the repayment performance[4] was as follows: production credit 85 percent and consumption credit 89 percent. In Benin, a nearly similar repayment performance was observed. Based on the loan amount due, production loans showed a repayment performance of 95 percent versus 90 percent for consumption loans in Benin. The data give no reason to fear worse repayment of consumption than production loans.

4. Repayment performance indicator defined as amount of debt service due and paid over total due.

Table 6: Cameroon: Savings Behavior by Gender (in Number of Savings Activities and Frs CFA)

	Male		Female		All	
	Number	Mean	Number	Mean	Number	Mean
Formal savings	28	47,842	8	31,912	36	44,302
Informal savings	100	33,456	105	17,630	205	25,350
Overall savings	121[a]	38,721	108[a]	19,504	229[a]	29,658

Notes: the data correspond to the recall period September 1990 until September 1991.

[a] The total number of observations is 441 from which 229 individuals reported savings activities. Since some individuals save in formal as well as in informal institutions, the total of these observations does not sum up to 229. “N” in this row refers to individuals who reported savings, not number of savings transactions as in the other rows.

Table 7: Cameroon: Primary Savings Motivation

(1) Row Percent (2) Column Percent		Interest	Easy Procedures	To Get a Loan	Confidence and Friendship	Only Choice	Insurance/ Avoid Problems with Institutions	Total Row Percent[a]
Bank	(1)	25.00	37.50	12.50	25.00	n/a	n/a	100.00
	(2)	4.44	10.34	4.55	1.56			
Credit union	(1)	55.56	11.11	11.11	22.22	n/a	n/a	100.00
	(2)	33.33	10.35	10.35	4.69			
ROSCA	(1)	3.33	6.67	12.22	63.33	14.44	n/a	100.00
	(2)	6.67	20.69	50.00	44.53	41.94		
ASCRA	(1)	21.05	11.40	6.14	52.63	8.77	n/a	100.00
	(2)	53.33	44.83	31.82	46.88	32.26		
Money keeper	(1)	n/a	33.33	n/a	66.67	n/a	n/a	100.00
	(2)		3.45		1.56			
Saving at home	(1)	n/a	5.26	n/a	n/a	36.84	57.89	99.00
	(2)		3.45			22.58	100.00	
Post office	(1)	25.00	50.00	n/a	25.00	n/a		100.00
	(2)	2.22	6.90		0.78			
All		16.92	10.90	8.27	48.12	11.65	7.14	100.00

Notes: The data correspond to the recall period September 1990 until September 1991. Total number of observations: 266.
n/a: not applicable.
[a] Numbers may not add up to 100 due to rounding.
Source: Schrieder, Heidhues, University of Hohenheim: Cameroon, Rural Credit Survey 1992.

Savings

In the Cameroon survey a person's average savings for the year 1991 amounted to Frs 29,660 CFA (equivalent to about US$110). Relating these savings to the average gross cash income[5] of the Cameroon sample, an average per capita savings rate of 13.9 percent would result. It is interesting that the savings rate for men with 17.4 percent was more than twice that for women with 8.7 percent. As Table 6 indicates, average savings per person were substantially higher in accounts with formal financial institutions than in those with informal institutions. However, the latter showed a much larger outreach to small savers, mobilizing in total more than three times the amount of formal institutions.

The reasons why people save a considerable part of their income despite their poverty may be inferred from the data given in Table 7. Savers were asked for their reasons of holding savings with particular institutions, groups or individuals. Confidence in an institution plays a key role; particularly informal credit and savings groups have been able to establish trust and confidence. Also, the level of interest paid is of considerable importance, both in formal and informal institutions. Notable is also the intention to turn to an institution or group for borrowing; this was given as a prime motive for membership in a ROSCA. Non-ROSCAs, as many members of ROSCAs and ASCRAs confirmed, are seen more as a safe keeping institution for deposits, although they normally also extend loans.

Conclusion

Rural farm households form an integrated unit where production and consumption activities are intertwined and inseparable; a distinction between consumption and production expenditures becomes inappropriate and often impossible.

Limiting credit to productive purposes or investments is inappropriate for developing sustainable rural financial institutions with wide coverage in rural areas. It leads to a neglect of rural households' other needs

5. For the recall period of September 1990 to September 1991, the average gross cash income estimate in the Cameroon survey was Frs 93,817 CFA. It derives from agriculture, livestock, salary, daily labor, non-salary and non-agricultural occupations.

which may at certain times have a higher priority. Households will then attempt either to divert production directed credit (which raises transactions costs) or turn to other (often higher cost) credit sources for their priority needs. The resulting increased costs may encourage defaulting on the "productive" credit which then we may well call counterproductive.

Limiting the use of credit tends to push borrowers into "illegitimate" activities and thus alienates the rural clientele whose trust and cooperation financial institutions need for developing durable, long-term customer-institution relations.

It is important to provide also consumption credit and other financial services demanded in rural areas. This will enhance customer confidence and trust, and enlarge the rural coverage which is essential for building strong financial institutions.

The study found substantial financial savings activities with average per capita savings rates of 14 percent; both men and women save. Offering savings facilities is, therefore, an important and worthwhile investment for rural finance institutions.

Given the high and manifold risks that rural households are exposed to and the lack of access to formal insurance facilities, financial markets have an important function to fulfill and a substantial potential to exploit. For providing insurance it is not the actual provision of credit, but more the potential access to funds in case of emergency that rural households need.

Our data do not support the arguments for directed credit that are based on the assumption that those borrowing for consumption are more negligent in repayment performance than borrowers for productive purposes. In fact, in Cameroon consumption loans were performing better than production loans.

In summary, building broadly-based, sustainable rural financial institutions requires that the whole range of financial needs of the rural population is being served. The needs include, apart from production purposes, savings facilities and risk protection. Institutions that address these needs have a wider outreach, are better accepted by the rural population and perform equally well or better in loan recovery.

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4

Structuring Credit to Manage Real Risks

J.D. Von Pischke[1]

If half the effort that has been spent throwing credit at the frontier [of formal finance] had been devoted to stimulating voluntary savings mobilization, the financial landscape in much of the Third World would probably be more attractive today. (And if the other half had been devoted to managing risk in credit relationships... this financial landscape would be a lush garden.) -- Finance at the Frontier (page 97)

Battered credit projects and institutions litter the rural financial landscape in many countries. Their fate has elements in common with destructive agricultural practices. For example, farmers know the circumstances in which use of heavy machinery destroys the structure of certain types of soils, excessive doses of fertilizer burn crops, overgrazing and overcropping lead to lower carrying capacities and yields, extravagant irrigation causes salinity and bad practices hasten erosion. Excess is also the cause of official credit's brilliant flashes across the rural financial sky and frequent crash. Too much credit has been issued. More accurately, too much credit has been issued for a particular purpose. This occurs easily when special lending programs are established to direct an artificially inflated supply of credit to officially identified "priority sectors" such as agriculture.

Too Much Credit for a Particular Purpose?

But how could too much credit ever be issued while farm households remain poor, rural children do not get enough to eat, farm women are beasts of burden, men are unemployed and modern agricultural technology can greatly increase crop yields and rural productivity? Is not credit the key to unlocking the solutions to these problems?[2] The answer to this question is complex but not difficult. Its exploration leads along paths to the green pastures and still waters of sustainable rural development and to the flowering of innovative financial architecture.

Credit Does Not Respond Directly to Deprivation

David H. Penny (1968) and Dale W Adams (1992) have pointed out that credit, or from a more useful perspective, debt, does not necessarily respond to the causes of deprivation and poverty. Examples include poverty caused by controls that keep produce prices artificially low, land tenure arrangements that exploit tenants and impede development of a land market, and the high risks of rainfed agriculture. One can also imagine the situation of producers in poor agricultural areas not well-served by infrastructure. Their remoteness keeps the costs of inputs high and the farmgate prices for produce low and inhibits economic production. In these types of situations credit does not address primary constraints. It may not necessarily liberate or effectively compensate target groups because scope for its productive use is limited.

Since these observations were made, interest has developed in micro-enterprise credit for members of households who have little effective access to or occasion to use modern commercial services or taxpayer or donor-financed infrastructure. A few of these small loan programs have been stunningly successful and widely cited by promoters and in the literature. However, prospects for their replicability are less certain, and caution is in order because so few programs that direct credit to specific groups, perceived as disadvantaged, have proved sustainable (Adams and Von Pischke, chapter 9).

Excessive Credit Creates Debt Crises

At the most basic level the observation that too much credit has been issued is tautological. Farmers and other rural borrowers who cannot repay their loans have clearly borrowed too much, creating a sort of barefoot debt crisis. The result is always a reduction in the value of credit outstanding through loan amounts written off, forgiven or otherwise lost.

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1. The author is grateful to H.A.J. Moll for helpful comments on an earlier draft.

2. A.H. Ballendux (1974) posed this question. Using a medical analogy he noted that agricultural credit "Administered in too great or too small a quantity, or at the wrong point in time, in the wrong way or under inappropriate circumstances...may do the patient more harm than good and may even endanger his life."

An upscale example of this effect was illustrated in the United States in the 1980s when farm debt grew several points beyond 20 percent of the nation's agricultural balance sheet (Johnson and others 1987; Penson 1987; White and Lyu 1988). In other words, farm debt financed more than 20 percent of farm assets. Several related factors fueled this crisis:

> During [the 1970s] boom, farmers as a group enjoyed a massive increase in real wealth, and some farmers borrowed heavily to increase their participation in these gains. In the bust of the 1980s, the entire increase in real wealth disappeared, and many heavily indebted farmers have been unable to repay their debt. Their personal financial crises are being managed through the restructuring of their obligations or are ending in the liquidation of their assets; that is, their "excess debt" is being forgiven or proceeds from sale or foreclosure of their assets are being applied to the indebtedness. In either case, such borrowers have lost their equity and their lenders have lost part of the funds they lent (Melichar 1987a. Quotations added.)

A large portion of the massive growth in farm credit came from the government's Farmers Home Administration and the government sponsored but privately owned Farm Credit System. Both expanded their market shares of farm debt. Commercial banks also increased their rural lending.

The surge in credit occurred in response to increases in land values associated with high crop prices in the 1970s, to congressional approval of higher levels of financing by the cooperative credit system (loans could exceed 90 percent of the value of land), and to a much smaller extent to public (political) alarm that wealthy aliens from oil-rich and other nations were buying the soil of the American heartland (while foreign-held farms occupy less than one percent of all US farmland).

But trees do not grow to the sky (Kindleberger 1978). Risk keeps the landscape on the ground[3]. Crop prices soon fell, declining land prices wiped $450,000 million off the nation's farm balance sheet, the oil-rich and others abroad became less interested in American farmland as an investment. Debt service burdens became crushing as farm incomes fell and many farmers who had gone into debt to expand their holdings found themselves in financial difficulty: they had too much debt. Land values were less than the loan amounts they were pledged to support, making it impossible for lenders to recover all amounts due by repossessing and selling land pledged as security.

The impact on the cooperative Farm Credit System was large, as it charged off US$3,755 million in bad loans between 1984 and 1988 (USDA). The Farm Credit System's 1985 loss of $2,690 million was the largest ever for a US financial institution and led to the restructuring of the system (Collender 1992; Harshbarger and Chite 1987). Other casualties included more than 200 commercial banks that were closed (Melichar 1987b) and the failure of at least 5 percent of American farmers (Wall Street Journal 1985). Melichar made a crude estimate in 1987 after the worst of the crisis that lender losses from 1986 onward would approximate $16,000 million (Melichar 1987a). The government gave new subsidies to farmers to help them out of debt and relaxed regulatory standards to save some weak lenders.

This was the biggest single debt crisis experienced by the US up to that the time. But farm credit problems were soon forgotten. They seemed like a tempest in a teapot as the savings and loan and banking crises of the 1980s burgeoned to an estimated $500,000 million mess, a cost spread over a number of years but which approximated the combined GDPs of neighboring Canada and Mexico at the time these troubles were becoming apparent.

Is it reasonable to cite a US example to argue that excessive credit should be avoided in poor countries? Yes, if affordability is considered. Follies of this type are relatively easily handled where agriculture absorbs about 1 percent of the labor force and where computers and industrial smokestacks outnumber farms. In all cases, repayment capacity, not need, is the relevant reference point for designing viable credit projects and nurturing sustainable institutions that can raise funds from depositors and investors.

Excessive Credit Is Difficult to Manage

At a similar tautological level it is clear that too much credit is issued when it goes beyond the capacity of lenders to manage. This may occur in several ways. In some poor countries financial housekeeping is deficient, and lenders on the fast track often get far ahead of their management information systems. They do not know their financial positions -- some have even lost track of their cash and bank balances -- and may not be able to bill borrowers regularly and reliably. Borrowers receive an important signal when they cannot promptly ascertain the lender's reckoning of the amount they owe. Repayment performance easily declines, causing lenders to lose money.

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3. Risk is used here as in non-technical English to denote both risk and uncertainty.

In other cases bookkeeping may be up to date, but rapidly expanding lenders cannot keep in touch with the reality of the market they serve. Visits to clients already in debt may become less frequent as more energy is directed at making new loans. Economic intelligence and technical issues may be discounted or ignored, especially if the lender is expected to help farmers and the economy through economic cycles by lending countercyclically.

Pressure to get the money out can lead to the decline and possibly the collapse of the lender's credit culture: the good questions that probe credit quality are less frequently asked and more frequently left unanswered. Promotions of high-volume lending officers highlight institutional priorities, and when credit quality problems surface several years later there may be few people left who have the stature, willingness or capacity to sort out the debacle. Any political force that stimulated the excessive issue of credit may be refocused on sparing pain for the debtors. The lender ends up much smaller and is often capable of providing only a low level of service to the community. Clearly, viable financial institutions provide better services over the long run than nonviable ones, or than a succession of nonviable lenders could.

Development Practice and Theory

Finally, some seasoned development assistance agencies now tend to back away from rural credit projects, implying that they, too, believe that the supply of credit has been excessive. Several major donors, including the World Bank and USAID, have reduced their lending through projects that provide lines of credit to financial intermediaries for on-lending to farmers or other rural activities. But their activities may have been too much too long. "Credit culture"[4] is easily destroyed and takes a long time to reconstruct. Transaction and risk costs are increased for society as a whole (Wall Street Journal 1985) as traditions of default and impaired contract enforcement become more firmly established.

Project analysis offers another but somewhat technical perspective on excessive credit. The theoretically optimum economic project size provides sufficient investment to reduce the project's marginal rate of return to the level of the opportunity cost of capital. (Few projects are of this magnitude because of budget reasons and institutional limitations.) Larger projects would not be economic because there would be better returns available on alternative projects elsewhere in the economy. Investment beyond the range prescribed by the opportunity cost of capital would be excessive in an economic sense.

This suggests that credit is excessive when many borrowers' marginal activities yield returns below the opportunity cost of capital. Clearly, positive returns on capital are generally required to support loan repayment, unless borrowers experiencing reverses are willing or can be forced to liquidate assets to satisfy their creditors.

Banking Ecology

It is possible to issue too much credit; doing so results in bad debt losses that may overwhelm institutions, destroying confidence and weakening contract enforcement. But are all bad debt losses by financial institutions to be deplored? Do they all defile the landscape? Not necessarily. A large tree may fall with only a small impact on the landscape. In fact, a lender that loses no money is not exploring opportunities for new business and is not behaving competitively. However, losses are a serious threat to all financial systems because these systems use large amounts of debt (such as deposits received from clients) and small amounts of their own capital.

The Banker's Problem

Commercial banks in OECD countries and elsewhere are increasingly being forced to maintain a risk-adjusted capital-to-assets ratio of 8 percent, as prescribed by the Basle guidelines. This ratio stipulates that every guilder of (risk-adjusted) total assets must be supported by 8 cents of their own capital. Own capital consists primarily of funds subscribed by shareholders and profits retained in the business. Risk adjustment weights assets according to arbitrary probabilities of loss: cash and short-term government securities issued in

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4. Credit culture has several meanings. It usually denotes the environment in which credit decisions are made in a financial institution. Strong credit cultures produce good loans, weak ones lead to low quality loan portfolios and bad debt losses. However, the term is increasingly applied to the attitudes, performance and expectations of borrowers or of a society at large with respect to the sanctity of loan contracts. In this usage the term is a PC (politically current) substitute for financial discipline or the older form, credit morality. Bouman uses *bishi* culture and ROSCA culture even more expansively to denote the dynamics of the operations of these two informal financial institutions (Bouman 1989: 66-69).

the currency in which the bank keeps its accounts are assumed to bear no risk, for example, and hence require no capital to support them. Loans outstanding to private borrowers are assumed to require an 8 percent capital base. The Basle guidelines were agreed under the sponsorship of the Bank for International Settlements in 1988 (Basle Committee). They were adopted in response to pressure on banks worldwide because of Third World and other doubtful debt, and because bankers from countries where relatively high capital-to-asset ratios (e.g., 8 percent) are the norm wanted to diminish competition from bankers in countries where lower ratios are traditional.

In commercial banking an annual return on total assets (ROA) of 1 percent constitutes good financial performance. This return is small compared to that of most other industries, but it still represents a reasonable return on banks' capital because there is so little of it. A 1 percent ROA for a bank with an 8 percent capital-to-assets ratio represents a 12.5 percent return on capital. These relationships demonstrate that finance has fine tolerances, or little margin for error.

Fine tolerances mean that the banker or financial analyst may view the financial landscape quite differently from the way the economist, agriculturist or sociologist sees it. Consider, for example, a team appraising a credit project that is expected to promote a new crop. The agriculturalist may be doing an excellent job by predicting within plus or minus 25 percent the average yield to be obtained from a new crop, and the rural sociologist may be doing an excellent job by predicting within plus or minus 50 percent the extent of target group adoption of the crop in any given year. The agricultural economist may be doing well by predicting within plus or minus 10 percent the average price that growers of the new crop will receive for their produce in the free market. The banker or financial analyst has a much smaller margin of error, in the order of 1 percent of average loan size, in predicting interest income, loan administration costs, collection rates and bad debt losses. In other words, the risk of error is great for the banker or financial analyst.

These close tolerances give bankers a peculiar point of view that enables them to bring constructive pessimism to bear in any situation. A project can do well as a narrowly economic, agricultural or sociological intervention, yet be a disaster financially for the institution making loans to participants and bearing the associated credit risk. Credit is really quite vulnerable, not the robust cutting edge of development so often portrayed.

Levels of Losses

Losses associated with debt crises lead to a reduction in confidence in financial markets (Kindleberger 1978). Reductions in confidence can increase the cost of funds to affected institutions, which must pay higher rates of interest on deposits or other funds to attract clients who prefer their untarnished competitors. Widespread confidence problems have a social cost, because they increase the costs of intermediation for clients as institutions seek to recapitalize themselves from profits. They may also have short-run dislocation or transaction costs if they result in the bankruptcy and closure of poorly performing intermediaries. (There may be long-run social benefits if this weeding out does not diminish the overall competitiveness of financial markets.) Because confidence is so critical in finance, risk receives great attention in financial markets and even from government regulators.

Three degrees of losses may be identified. The first is within an affordable creative margin of innovation, which is part of the natural evolution and regeneration of the landscape. These financial losses do not diminish confidence in financial markets. Their causes are easily corrected and their impact easily absorbed by lenders' capital, and the greater the capital relative to assets the greater the base of innovation. These losses provide important information that can be acted upon by the would-be innovator and by competitors, redirecting energy toward more sustainable behavior. Hence, these losses cannot really be attributed to excessive credit creation.

The second level is a larger degree of failure that credit institutions and financial markets or institutions can accommodate in unusual circumstances without collapse. Bad loans that accompany this type of failure bring no more than temporary disruption to these markets. While some confidence is lost for a time, a level of confidence is confirmed by the market or institution's continued operation and eventual recovery. The landscape grows over and around the problem.

Finally, a higher level of failure causes long-term damage to the ability of credit markets and institutions to grow and perform efficiently. This degree of failure overwhelms normal operations and risk management. The landscape is degraded and forever altered. Credit has been excessive.

Sustainability or Green Finance

Losses from excessive credit issue jeopardize the eventual quality of services available to those who receive excessive credit. This occurs because money-losing lenders rarely create robust capacity. At some point these lenders lose their credibility and the support of the parties that made it possible for them to sustain losses for long periods. Government priorities may change, donor fads alter. This often occurs just when the continued supply of funds is most important, such as in the midst of a downturn in the economy or in a period of structural change. Because of the larger factors that cause credit problems, old priorities are abandoned or downgraded. These often include subsidized programs and unprofitable state-owned ventures.

Because of the inevitability of adversity, financial institutions' capacity to survive is best served by building strong balance sheets and high-quality earnings. This is most likely to occur in competitive situations and when financial intermediaries create strong links with their clients and have sufficient capital to enable them to innovate in providing financial services. Institutions that are not competitive are unlikely to have the incentives required to ensure their survival over the long run, regardless of the economic power they exert in the short run. Because their monopoly shields them from market forces, they may not adjust to changing conditions. They tend to become brittle, often collapsing relatively quickly at a point when they have clearly outlived their mandate. Monopoly may appear to be the most stable form of economic organization, but because it is not attuned to developments in changing markets and societies it proves to be especially vulnerable.

In summary, excessive credit arises from an overestimation of what credit can accomplish, from an unrealistic view of borrowers' repayment commitment or capacity, from inattention to the requirements for effective loan administration by lenders, and from lack of appreciation of the damage to financial institutions and to society caused by bad debt losses beyond the rather small limit that is easily absorbed by lenders' capital and public confidence.

Risk and Risk Management

The general failure to build sustainable financial systems and institutions with development dollars or generous guilders suggests that a new strategy and role are required for financial interventions made in an effort to develop economies and to empower people and institutions. The new strategy and role proposed here shifts the emphasis from concern for the quantity of directed credit to its quality. The ingredients for this revision are inherent in finance and develop naturally when financial markets are not gagged with regulations or force-fed with ill-conceived credit projects. Respect for what might be called "financial values" can improve financial landscapes.

Risk is the essential element of finance that offers developers their greatest opportunity in using financial markets. This is paradoxical, because it is risk that unseats systems, institutions and projects that issue excessive credit. Beyond some dynamic but sustainable equilibrium, risk translates otherwise rational behavior into forces that depreciate credit contracts and destroy credit institutions. Debtors are unable to repay, creditors are unable to collect, or both. But risk is the blessing as well as the curse of finance. Developers and landscape architects using finance as their garden should be inordinately concerned with and profoundly fascinated by risk.

Dimensions of Risk

The most visible dimension of banking is the intermediation of funds or dealing in money. Deposits provided by some are transformed into loans for others. This process is a very powerful one that all governments and many other organizations and people seek to control. It is also often regarded as the financial sector's greatest contribution to a market economy and to development.

Beneath the surface of dealing in money is an equally important or, in the long run, possibly more important process: the intermediation of risk. Risk may be defined simply as variability of returns, or as failure to achieve financial objectives or expectations. Intermediation between depositors and borrowers cannot occur without a simultaneous intermediation of risk.

In the transformation of a deposit into a loan, the transformation of risk is subtle and complex. To illustrate this point, assume that the depositor is a private individual and that the borrower is a business. The depositor expects that the deposit is less risky than holding cash at home or in a secret place. The depositor believes that money in the bank is safe from theft, that there is less risk that it will be spent on impulse because it is not instantly available, and that the existence of the deposit will be kept in confidence by the banker except as may otherwise be required by the state.

The banker knows that there is risk in lending. Risk motivates bankers' efforts to remain liquid so that payments can be made on demand and to remain solvent by using profits to build capital. The banker's risk includes the possibility that the purpose for which credit is provided may not be remunerative, leaving the borrower with insufficient funds with which to repay, and also the possibility that the borrower may attempt to avoid repayment in spite of having funds available.

But there is also another element of risk transformation. Owners of a business invest their own funds in their enterprise, and these are at risk. If the business fails the owners lose some or all of these funds. As long as the business is financed only by the owners' funds, the owners' risk on this investment is identical to the risk facing the business. When the owners borrow for the business, their risk increases because their returns are subject to greater variability. They are willing to take this risk because they believe the returns from using credit are greater than the costs of doing so.

This occurs because a loan creates a hierarchy of claims: the lender expects and has a legal right to a steady or fixed return in the form of payment of interest and repayment of principal, while the owners take a residual position that receives variable returns. Debt service obligations diminish the owners' returns from the business disproportionately in bad times when flows are small, while providing the opportunity for disproportionately larger gains in good times when the returns obtained from using credit are much greater than the cost of credit. Hence, borrowing increases the owners' risk, as their returns are more variable than those of the business. In addition, lenders often place conditions on their loans. Compliance may increase borrowers' costs and risks, including the cost of reporting and the loss of flexibility in managing the business. Obviously they borrow in the expectation that bearing larger risks, up to some subjective point, generates larger returns.

Information Is Required to Manage Risk

Procedures used to intermediate funds in highly developed financial centers are rather easily copied in less developed ones, but processes used to manage risk are much more difficult to transplant. Because financial intermediation transfers funds and risk simultaneously, failure to cope with risk undermines attempts to intermediate funds successfully. This occurs because bad loans destroy the confidence on which intermediation is based. Hence, risk should receive special attention in all efforts to use finance to stimulate development.

Information is the most important ingredient in risk management. The greater the amount of relevant, valid and timely data about the affairs of a loan applicant and the markets in which the applicant operates, the more refined the rational credit or investment decision. With good information, the operations of an enterprise can be better understood. In countries with highly developed financial markets, accounting and disclosure standards have developed to facilitate the flow of information to investors and creditors. Projections of a firm's financial performance can be made more skillfully, yielding a higher probability of accuracy. These reduce transaction costs and promote wider access to credit and equity capital.

Information is used to create confidence in financial markets. Confidence is extremely important because finance is always risky. Risk arises because the future is unknown and because financial markets trade cash in the present for promises of returns in the future. Confidence is a judgment, a state of mind, an emotion, an impression, even if backed by complex and profound analyses, making information especially important.

Information, Risk and the Lending Decision

Organization of information increases its power. Table 1 illustrates conventional information organization and use in agricultural or rural credit projects. This table portrays a very simplified example of farm budgets used by donors in agricultural credit project design. This budget is for a single season and is driven by the increase in purchased inputs with the project (line 6). Similar budgets for on-farm investments with a longer life cover correspondingly longer periods.

The Conventional Approach

Budgets of this sort are intended to be representative of the potential for large numbers of farms or hectares or of what might be accomplished in specified areas. They are also used to calculate rates of return, especially the economic rate of return that attempts to indicate that "the economy" would benefit from donor intervention through investment in an activity. In this context risk may not be viewed as relevant or interesting because the sequence of good, normal and bad years is impossible to predict and because good and bad years offset each other to some extent.

"Sensitivity analysis" provides an indication of a farm budget's resilience by arbitrarily adjusting the rate of return to reflect larger-than-expected costs (e.g. more than 10 percent) and lower-than-expected revenues (e.g. less than 20 percent). The discounted cost stream and the discounted benefit stream may even be graphed to illustrate their slopes at the cross-over point at which they meet to yield the rate of return. If their slopes are steep a change in either, denoted by a parallel shift, will produce a smaller impact on the rate of return than if their slopes are more nearly horizontal. This gives a perspective on risk, but few if anyprojects or support for specific farm enterprises (crops) were ever redesigned or abandoned as a result of sensitivity analysis.

However, the format used in Table 1 makes no explicit allowance for risk. This is not to say that risk has been entirely ignored: the agronomist who recommended the crop to be planted ("produce" on line 1 in this example) may have had a good nose for risk, reflected in the projected yield and recommended inputs. The

Table 1: Hypothetical Farm Budget

Category	Without Project	With Project
1. Produce (tons)	5	10
2. Consumed on farm (tons)	2	2
3. Marketed produce (tons)	3	8
4. Farmgate price per ton ($)	400	400
5. Total farm cash receipts ($)	1200	3200
6. Purchased inputs ($)	200	1000
7. Net benefit before financing ($)	1000	2200

agricultural economist may likewise have researched farmgate prices and input costs very carefully (lines 4 and 6 in Table 1).

A problem -- a big problem -- arises when the format used in Table 1 is also used to determine loan size, as has customarily been the case. In this example the incremental inputs required, which cost $800, double outputs, from 5 tons to 10 tons. This budget would customarily be used to justify a loan of $640, $720, $760 or $800. Why these amounts? Simply because donors usually use rules of thumb, or formula lending approaches: loan size equals 80 percent, 90 percent, 95 percent or 100 percent of incremental input or investment costs. There seems to be no particular conceptual basis for selecting any one of these high percentages, but there is probably a bias toward the high end of the range when potential borrowers are viewed as poor.

These high levels of financing almost inevitably run into problems when bad years occur. These problems may be avoided or minimized when the loan finances only a small portion of the economic activities of a borrower who has a good relationship with a lender, and when methods of handling bad years are thought out in advance by the lender. These precautions appear to be the exception in donor-supported credit projects.

High levels of debt create large debt servicing requirements that may be difficult for borrowers to meet or which discourage them from repaying out of a diminished supply of funds available to support their normal consumption levels (beyond the 2 tons of produce consumed on the farm) and their customary social obligations. The budget approach illustrated in Table 1 virtually guarantees that loans will be excessively large.

Risk Adjustment

One dimension of organization of information in finance is the testing of data regarding variances from the norm or expected outcome. Variance-centered analysis is important because of risk, which deflects results from the normal or expected outcome. Because of the narrow margins for error in credit markets, skillful loan providers have a good feel for risk.

What would a risk-adjusted budget look like? Table 2 offers another highly simplified example. Risk adjustment, properly done, provides opportunities for protecting the lender from lending too much, for protecting the borrower from taking on too much debt, and of greatest importance, for examining real risks that borrowers are exposed to and searching for ways of reducing or managing real risk. Whereas farm budgets have customarily been directed at deriving a representative return on an investment, risk adjustment focuses primarily on the size of loan that is sustainable for an on-farm investment.

Table 2: Hypothetical Risk-Adjusted Farm Budget

Category	Without Project	With Project Normal Year	Bad Year
A. Produce (tons)	5	10	5
B. Consumed on farm (tons)	2	2	2
C. Marketed produce (tons)	3	8	3
D. Farmgate price per ton ($)	400	400	550
E. Total farm cash receipt ($)	1200	3200	1650
F. Purchased inputs ($)	200	1000	900
G. Net benefit before financing ($)	1000	2200	750
H. Senior claims ($)	500	600	600
I. Repayment capacity ($) = uncommitted cash flow	500	1600	150
J. Loan received ($)	0	1333	125
K. Debt service ($) (principal + 20% interest)	0	1600	150

The starting point for risk adjustment is identification of what is most likely to go wrong. Risk manifests itself in real hazards and events, such as the death of a cow or failure of a crop or a machine, not in mechanical assumptions such as a 10 percent cost increase and a 20 percent decline in revenues. Hence, risk adjustment has to go beyond sensitivity analysis.

In other words, material risks should be identified and their likely impact explored and quantified. Once the question about what is most likely to go wrong is answered, the next question is, "What else is likely to go wrong?" Lines A through G in Table 2 provide a simple format that incorporates risk, defined as a "bad year" or season. In this hypothetical example, a reduction in output (line A) is partially offset by an increase in prices (line G), on the assumption that the yield shortfall is generalized, yet total farm cash receipts (line E) fall by almost half.

It would be easy to cook up risk-adjusted models like Table 2, based on hypothetical situations without identifying what the real risk is that would create a "bad year". Is it realistic to assume that sufficient information would be available to permit risk adjustment based on real underlying factors? If it is possible to predict yields and prices it is also possible to predict risk. In other words, evaluation of risk is part of any investment decision and may even be included in a gambler's calculus. Many extension service field staff have an idea of what types of adversity can be expected and the frequency with which they are encountered.

Farmers also have expectations and experience that they are very clear about when they are questioned about bad years, reversals and losses. But they have not been sufficiently consulted in credit project design. Once they are consulted, real risk and measures to deal with real risk, in addition to the possibility of providing more credit, should become apparent and accepted as a priority and objective of development intervention.

In this way developers and lenders' interest in providing credit can open windows on problems, defined here as risk, facing borrowers and potential borrowers. The result should be more mutually satisfying relationships between lenders and their rural borrowers. A lender or development agency that viewed risk identification and management as a major element in development strategy would accumulate much information and experience. This could provide a powerful platform for helping intended beneficiaries around or over the things that limit their progress and that are within their control or the lender's control.

Senior Claims

Table 2 takes risk analysis further by including senior claims (line H). These are obligations that the borrower considers more important than repaying the lender. They pose a risk to the lender. Senior claims that are not considered when a loan is issued increase the probability that the loan will not be repaid. Senior claims include survival or keeping the farm business operating, paying schools fees and taxes, seizing extraordinary opportunities, and meeting social obligations that cannot be side-stepped except at great cost. They may also include things that borrowers always wanted to do or acquire but felt too poor to do so. Senior claims are expected to increase with the expansion in farm income (line H, with versus without project).

Senior claims are not immutable. Sustainable lenders that establish good relationships with their borrowers in effect lever their way up the borrower's ladder of claims. Informal finance demonstrates this effect: to default on a RoSCA obligation is a very serious matter. Contributions to the periodic hand take precedence over many alternative expenditures that would otherwise occur, indicating that few claims on members are senior to those of the RoSCA. Overall, informal lenders are likely to be repaid before formal lenders, newer lenders after older lenders, lenders close by before distant ones (Shipton 1990). Here again there are mountains of information on senior claims waiting to be mined by bankers and rural developers.

Sizing Loans to Accommodate Risk

Table 2 indicates repayment capacity (line I) adjusted for risk and for senior claims. The estimated amount, $150, is quite small compared to the normal year level of $1600. What size loan should be issued? Assuming a 20 percent interest charge a loan could be issued for any amount between $125 and $1333 (line J). How would lenders use these data rationally? The maximum loan would not appear to have to exceed the $800 in incremental input costs (line F, normal year with versus without project). (Occasionally project designers have applied high, arbitrary financing percentages to total costs, not to incremental costs, lending more than is theoretically related to the difference between the with and without project cases.) Many lenders would not issue a loan of $800 in view of the risk suggested by the difference between repayment capacity in a normal and bad year.

A loan of $125 would presumably not exceed the borrower's capacity to repay every year within the range of adversity and senior claims considered reasonable. But would a loan of $125 make sense? If it were viewed as trivial, it would be less likely to be repaid. Would the borrower be able to undertake the incremental $800 investment in inputs if a loan of only $125 were issued? If not, what would make sense, and most importantly, for which type of lender?

While some lenders would refuse to become involved in such situations, others might be willing to accept "interest only" from distressed clients in a bad year. Payment of interest shows goodwill and commitment on the part of the distressed borrower and permits the lender to collect income on the loan. Assuming a 20 percent interest charge and a minimum repayment capacity of $150, a loan of $750 could be issued ($150/x = 0.2/1). The principal amount, $750, could be recouped over normal and good years that could be expected to recur, because good year repayment capacity is $1600. A strategy of this type assumes that lender and borrower maintain a long term relationship.

Within an enduring relationship there are a number of other solutions to the puzzle of deciding how much to lend or borrow. One approach to the problem would be to calculate how long it would take to recover a specified amount in arrears over a sequence of bad, normal and good years, assuming always that new loans will have to be forthcoming each season for the borrower to continue to be productive and in a position to service debt and for the lender to retain a relatively senior claim. New lending in the face of adversity, or following adversity, is especially important in assisting the borrower's recovery and is one means of risk management. Measures to manage risk that are thought out in advance of its impact have rarely been incorporated in the design of donor-supported credit projects and components.

A lender with no flexibility could not agree to anything less than repayment in full on the due date. A strategy of collecting interest only in an adverse situation or lending new money when old money is in arrears would not be worth considering. In this extreme situation the lender cannot manage risk. The loan is bad and the borrower is abandoned, creating the worst possible real and financial outcomes, assuming limited alternatives available to each.

Yet some degree of risk management is common in finance. The source of a lender's flexibility is risk management. A very simple example: lenders do not want to run out of cash, to be illiquid, because this destroys confidence. Therefore they keep cash in reserve: commercial banks often have loan-to-deposit ratios as low as 50 or 60 percent. Required reserves kept with the central bank absorb part of the difference, some is kept in the form of vault cash, and balances with other banks and investments in government securities account for most of the remainder. In effect, these provide different levels of insurance against running out of cash. Another simple example is portfolio diversification by type of borrower, geographically, and by loan maturity.

Bangladesh Awash, Grameen Bank Awash with Cash

An example of successful risk management is Grameen Bank's financial structure at the time of the disastrous 1988 floods in Bangladesh. How should a bank be structured to survive the inundations that cover a third to a half of Bangladesh's landscape every few years? Half of Grameen's assets consisted of cash on deposit with other banks in Bangladesh. This raised the eyebrows of some observers from development assistance agencies and NGOs who thought that this money should be loaned to desperately poor people rather than kept in banks.

But while the waters were receding, Grameen Bank's Yunus gave the following instructions to his staff: (1) go to the villages and tell our members that every day they are not working they are eating their assets, and that is bad because it only makes them poorer, (2) members who have lost their loan-financed assets in the flood can have new loans equal in size to their old loans, (3) all restrictions on the withdrawal of the various forms of savings deposits members hold with the Bank are waived -- anyone can withdraw on demand, and (4) do not mention loan repayment: when members are in a position to repay they will repay. Members took new loans. Very few withdrawals were made from deposit accounts, possibly because members valued these as reserves against another rainy day.

Is it possible for a bank to design a better approach to risk management than this, one that sustains the dignity and aspirations of member-borrowers in such a way that their commitment to Grameen (or the seniority of the Bank's claim on them) is reinforced rather than weakened by catastrophe, that could be accommodated within normal banking procedures, and that could be undertaken at short notice without having to obtain approvals from any other source such as a donor or government authority? No loans were forgiven, and Grameen lost relatively little from the tragedy.

Grameen's example demonstrates several things. First, it shows that the fortunes of borrowers and lenders are tied, giving both a stake in successful risk management. Second, it shows how risk management by either party can benefit the other. Third, it demonstrates the importance of financial innovation to successful risk management, in this case the highly unconventional level of cash reserves. Periodic massive flooding is entirely predictable in Bangladesh, although the year in which it strikes is not, and Grameen Bank was essentially in a position to reproduce itself when the inevitable adversity struck.

Other devices bankers use to control the risk of illiquidity include back-up lines of credit from other banks and rediscount facilities from the central bank. Most commercial lenders diversify their loan portfolios so that problems in one industry or sector have a relatively small impact on the overall portfolio. Even in Grameen's case, some of its borrowers were in higher areas that escaped flooding. Debt renegotiation is another means that gives flexibility to the distressed party. Renegotiation forgiving some or all of the amount due demonstrates partial or complete failure of previous levels of risk management, however.

The Opportunity to Manage Real Risks

Disillusionment has spread regarding the use of credit to stimulate sustainable development. This is the normal *denouement* of popular speculative indulgences (Kindleberger 1978), such as the incredible seventeenth century fascination with tulips, which have never seemed quite the same since. Now, creditomania, too, has run its course as excessive credit self-destructs and donors' credit project flows diminish.

But there are exceptions to this disillusionment. First there have always been those who have no intention of building sustainable financial arrangements. They often cry out that, "Something must be done!" in the belief that present need is so great or political imperatives are so overwhelming, (and probably always will be), that nurturing the financial landscape is a secondary, more remote or even unrealistic task. When something has to be done, credit has often been seen as the easiest way to do it, especially when risk is ignored, as it usually has been in fashioning credit terms. This is not to say that people with this view set out to destroy the landscape. If they can build in a little viability along the way they are often willing to do so, as long as the cost to their money-moving agenda is not too great.

Second are those who are not greatly concerned about the consequences of their attempts to stimulate development. Their view is that good intentions are sufficient, that policies and actions should be evaluated on the basis of intentions. This position is under increasing attack as more and more evaluation is done and as more widely-publicized and -debated results divest intentions of their credibility and make developers more accountable.

There is now a special opportunity for the disillusioned, for those who want to turn damaged financial landscapes into lush gardens, and even for some who are willing to build in a little viability here and there in exchange for providing smaller, smarter loans to help their client lenders and ultimate borrowers deal more effectively with risk. Current circumstances present the largest opportunity for innovation since the surge in interest in credit as a vehicle for development assistance at the household and firm level began in the 1960s.

Finance as a Window on Risk

This opportunity is the potential for using finance as a window on risk. This window opens with the realization that financial flows are information flows, that credit inevitably creates risk, and that these features, already combined in loan contracts and credit markets, can also be combined in an enlightening way in developmental interventions. This perspective leads naturally to concern for identifying risks and quantifying their impacts. This is the first step in risk management. From it develop attempts to deal with real risk -- the things likely to go wrong. These can be avoided or managed in ways that reduce their incidence and impact.

Risk management systems can include real measures (e.g., spraying crops) and financial measures (e.g., saving for the rainy day or linking savings and credit). These systems begin with attention to real risk. They reflect this in loan sizing and in credit terms and conditions. They go on to protect financial relationships by structuring institutional responses to risk that go beyond specific transactions. These responses include the lender's financial structure and mix of services provided to clients.

Risk as a Window on Finance

A risk-embracing approach should move developers toward a broader, more inclusive view of the realms of human experience from which relevant information about risk can be gathered and analyzed. For example, the family, village and culture are surely the institutions that have stood the test of time as means of risk management (Halstead and O'Shea 1989). When this is realized the contributions of sociology and anthropology can be more fully used to balance the stylized concerns of economics, and the hollow view of finance as another name for cash, in defining development problems and what might be done about them.

At the big end of the financial market in major financial centers, many new instruments, techniques and markets have developed during the last 50 years that have created new ways to manage risk by redefining it and by transferring its impact. These include commercial paper, options and futures on many commodities and securities, securitization of debt, application of duration analysis in portfolio management, and numerous others, without even considering the markets for insurance and guarantees. An especially interesting example was the "junk bond" episode in the US in which financiers redefined risks by repackaging them and then took the lead in locating investors and entrepreneurs to bear them. As with farm debt, promotion of high yield bonds involved unsustainable extremes that eventually unraveled part of the market that was created.

Financial measures to manage risk have been barely explored at the small end of the financial market serving households and small businesses, including farms. New attempts to use finance to manage risks at the small end, at the grass roots part of the landscape, have to increase the flexibility of all parties to a credit transaction to react to adversity without breaking their explicit loan contract or their implicit financial relationship.

This requires innovation, which in credit means lengthening term structures so that larger amounts of credit can be repaid over longer periods of time, reducing transaction costs so that more households and firms have access to financial markets, and redefining the valuation processes that create the basis for credit relationships (Von Pischke 1991). Successful financial innovations lower costs and increase debt capacity in a developmentally sustainable manner. This task should occupy and preoccupy developers well into the next century.

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5

The Performance of Banks in Rural Financial Markets

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In the 1960s and 1970s national policymakers charged many rural banks with the provision of cheap credit to small farmers, small fishermen, or broadly speaking, rural households with small-scale enterprises. The performance of these institutions and the programs, projects and schemes they supported, however, remained below expectations. A new thinking about rural finance and its role in development, based on the concept of the Rural Financial Market (RFM), clearly demonstrated the shortcomings of the cheap credit policy. It enabled a more balanced understanding of the roles of rural banks, informal intermediaries and their (potential) clients in the supply of and demand for financial services (Adams 1983; Donald 1976; Von Pischke 1981). The new thinking also resulted in a growing recognition that governments should refrain from direct participation in banking and concentrate on policies that establish and maintain confidence in financial institutions. Such a new role of government in finance is a pre-condition for the provision of sustainable financial services by banks. Of course, this is not the only issue. Various studies have explored other factors that strongly affect the provision of rural banking services (Binswanger and Rozenzweig 1986; Schmidt and Kropp 1987; Von Pischke 1991).

This paper focuses on the costs of financial intermediation and its relation to the scale of operation. The calculation and monitoring of costs is of central importance when rural banks[2] pursue the socially desirable objective of providing financial services to new clients. Emphasis on reaching new clients without due attention to costs, and the control of costs in particular, leads invariably to operating losses which sooner or later result in a reduction or termination of services provided. From a long-term perspective, the objective to reach new clients should thus necessarily be linked with attention to costs, or in broader terms: with the objective to operate on a financially viable basis.

Rural banks trying to achieve these two objectives simultaneously are faced with a host of questions regarding the demand for various types of financial services by their new clients, and their own organizational, operational and financial capabilities to meet this demand. Answering these questions requires analysis, followed by experiments to explore the feasibility of new organizational approaches and new methods of operation. The discussion of lending costs should therefore be part of evaluation of existing banking services and of planned experiments to widen to scope of services.

Rural Financial Markets and the Position of Banks

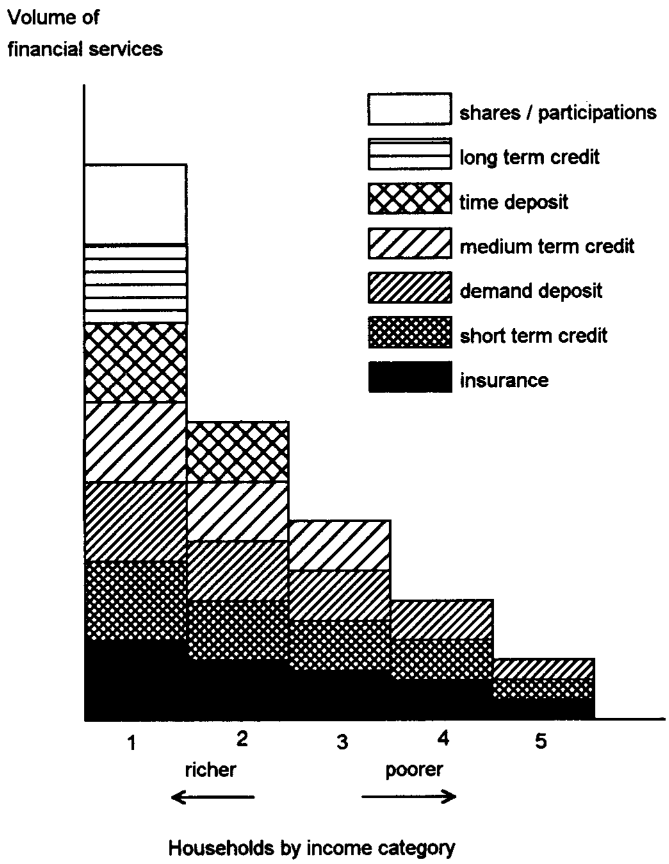
Rural financial markets consist of relationships between buyers and sellers of financial assets in a rural economy. Relationships develop between market parties through financial transactions, such as: lending, borrowing, saving, insuring, and the transfer of ownership participation in enterprises. Funds are exchanged in these transactions for other financial assets: debt claims or ownership claims. Participants in the rural financial markets are the rural households and intermediaries operating between buyers and sellers of financial assets to bridge preferences for quantity, time, risk and space. Intermediaries are usually divided into informal intermediaries such as traders, moneylenders, indigenous bankers, landlords and pawnbrokers, and formal intermediaries like banks, specialized credit institutions and cooperatives.

The specification of financial assets in terms of size, maturity or tenor, and additional conditions is linked to the type of financial transaction in which they are produced, and to the type of intermediary involved. It is therefore useful to speak of “financial services” and specify these services as short-term lending, insurance against risk, etc., possibly in combination with classifications of “formal” or “informal”, to identify the types of financial assets. The rural financial market can then be described in terms of demand for and supply of financial services.

The potential demand for financial services, that is, the capacity of households to engage in financial transactions, is related to rural incomes, which in turn are related to the stage of development (Von Stockhausen 1984). This demand has two dimensions, a qualitative aspect including the types of services, and a quantitative aspect covering the size or scale of individual services. The total demand for financial services in an RFM,

1. The author is grateful to J.D. Von Pischke for comments on an earlier draft.
2. The term “rural banks” is used here for banks, cooperatives, credit schemes and programs etc. operating in the formal or semi-formal sector.

Figure 1: Demand for Financial Services by Households per Income Category



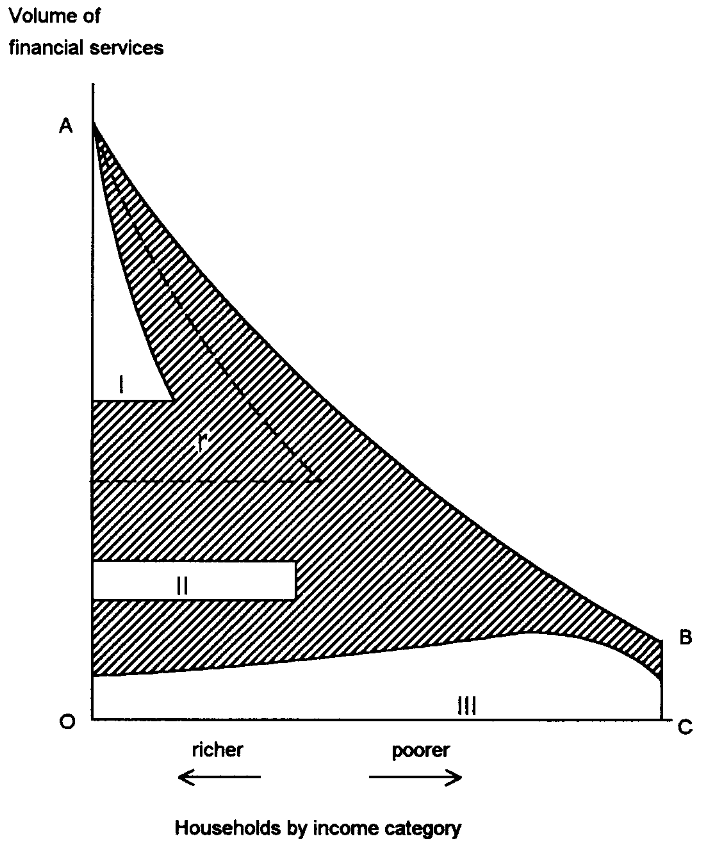
specified by type and size, is thus related to the total household income in a rural area. Incomes of rural households have a certain distribution, and we may assume that the richer households have a demand for a wider range of services with a larger size than households with lower incomes. The demand for financial services in an RFM by households divided into five income categories each containing 20 percent of the population is stated for a hypothetical case in Figure 1.

The households with the highest incomes, shown in column 1, have a demand for seven types of financial services, each with a certain volume. The households in the lower income categories, columns 2 to 5, require a less diversified range of services and the total volume demanded per household as well as the volume per individual service becomes smaller with lower incomes.

The services which are potentially attractive to rural clients are not necessarily all available, or available in appropriate amounts, creating an unfulfilled demand for financial services in RFMs. This situation is depicted in Figure 2. Households are grouped according to their incomes on the X-axis with the highest income households near O, and the total volume of services demanded per household on the Y-axis. The area OABC represents the total volume of financial services demanded by households in a rural area. Curve BA reflects increasing demand per household as incomes increase; the vertical line BC indicates that even the poorest households desire a certain volume of services. The potential demand in Figure 2 is only partly met by three types of institutions or relationships. The area indicated by I refers to the services provided by banks: part of the richest households is reached with part of the services they desire. Area II represents services provided by Specialized Farm Credit Institutions. These offer a single type of service, credit in fixed amounts, which is depicted by the narrow rectangular area. The SFCI reaches more households than banks do (the side along the X-axis is longer), but the SFCI, too, reaches the richer households. Area III refers to informal financial relationships: all households participate, but with least participation by the richer households and the very poor households: the rich because they have access to the formal sector, and the poor because they are limited by their small financial capacity. This picture of an RFM is hypothetical, but the relative positions of the three types of financial institutions or relationships and the indication that there is an unfulfilled demand for financial services, is realistic.

This perspective on RFMs provides a sharper focus on the position of banks, and on the central issue resulting from the two objectives stated in the introduction: how can a bank extend its services to more house-

Figure 2: Demand for and Supply of Financial Services in Rural Financial Market



holds while remaining or becoming financially viable? Extension of services must be sought in two directions: (1) more clients with financial capacity similar to that of clients already reached, which generally means clients farther away from the rural center in which banks are usually located, and (2) more clients with lower incomes than clients already reached, which means new types of services adjusted in size and conditions to the smaller financial capacity of these households. In Figure 2 the extension of services in two directions is depicted by the area I'. Extension of services towards more clients, those further away and those with smaller financial capacity, dramatically increases costs of banks. Addressing the central issue thus requires careful balancing between costs, returns and the increased scale of operation in order not to endanger the condition of financial viability. This is especially the case for an expansion of lending services because screening of applicants, monitoring of borrowers, and enforcement of repayment involve considerable expenditures. For these reasons the cost of lending receives specific attention in this chapter.

The provision of financial services such as money transfer and insurance might be worth considering as well, the former especially in areas where part of the population work elsewhere. The expenditures and revenues of these types of services can be estimated with much less uncertainty than lending services, and their introduction does not involve major risks. These supplementary financial services might improve the profitability of a bank through economies of scope.

The Cost of Lending

The cost of lending is central to a bank's financial viability, and thus to its ability to provide services on a permanent basis. The cost of lending is composed of (1) the costs of funds which include interest paid to savers, depositors and other suppliers of funds, and the administrative costs of handling savings accounts and deposits; and (2) the cost of providing loans which consists of administrative costs for screening, monitoring and loan recovery and the cost of default. Lending costs thus determine the bank's ability to attract funds and to allocate these to borrowers.

Various authors have discussed banks' lending costs and developed formulas to calculate these costs (Bottomley 1975; Moll 1982; Lee and Baker 1984; Nyanin 1983; Anderson and Khambata 1985). Their formulas are basically the same, although definitions and derivations vary somewhat. I would like to discuss formula (1) here:

Formula (1): the cost of lending (i) = [(c/u) + a + d] / (1 – d)

c = cost of funds for the total period of the loan, as a proportion of the loan amount;
u = utilization of funds: average proportion of the available funds for loans which is outstanding;
a = administrative costs in proportion of loan size;
d = default rate: the proportion of loans not repaid;
i = lending cost as a proportion of the loan.

Formula (1) has the advantage that the cost due to a limited utilization of the funds available for lending, an important aspect in rural areas experiencing seasonality of agriculture, is explicitly stated. This formula can be used to calculate the cost of lending under various conditions, as shown by cases (i) to (iv) in Table 1. The cases in the table demonstrate the effects on the cost of lending of:

1. Loan size, administrative costs in absolute terms are fairly independent of loan size; a small loan, represented by case (i), has proportionally larger administrative costs than a larger loan, case (ii), and requires a higher interest rate.
2. Loan tenor or maturity; cases (iii) and (iv) differ only in tenor but case (iii) requires an interest of 8.7 percent per month whereas case (iv) requires 3.2 percent per month.

The large impact of loan tenor on lending cost is due to the fact that administrative costs and cost of default (expressed as proportion of loans not repaid) must be recovered in a much shorter period. The effect of small loans and loans of short tenor on lending cost is especially relevant for rural banks that want to extend their services to new customers, as their demand is initially for these types of loans.

The operational application of the formula to study the effects of present and new lending operations is, however, subject to two limitations:

1. The cost parameters available are stated in proportions that reflect the average present situation with regard to loan size and tenor; for an appraisal of new lending services -- short term and small -- the cost parameters need to be defined accordingly.
2. The volume of loans provided or expectedly to be provided is not taken into account. Volume is a vital issue for rural banks, because their fixed costs can be covered at a certain interest rate only if a sufficient volume of services can be provided.

The two limitations can be lifted simultaneously by incorporating lending operations in absolute terms in the formula. The lending operations of a bank in year t can be described by three parameters: loan volume (L_{vt}), loan amount (L_{at}), and number of loans (L_{nt}). The loan volume L_v is expressed in currency unit periods: a loan of 100 Rupiahs (Rp) provided for three years on the first of March in year t, represents a loan volume for that year of 10 times 100 is 1,000 Rpmonths. Compilation of all loans in this way is rather cumbersome. Therefore, the sum of outstanding loans at the end of each month of year t can be used as a proxy for loan volume in year t expressed in Rpmonth. The loan amount L_{at} is the sum of new loans provided in year t; the number of loans provided is L_{nt}.

With these three parameters lending operations formula (1) can be expanded to reflect lending costs more precisely, either as the interest rate on loans required to cover all annual expenditures, or as an absolute amount of annual expenditures. The total costs of funds is proportionally related to the loan volume (L_{vt}). The direct

Table 1: Cost of Lending

Case	Loan tenor	Cost of funds (c)	Utiliz. funds (u)	Admin. cost (a)	Default Rate (d)	*Cost of Lending* Total	Per month
	month	%	%	%	%	%	%
(i)	6	6.0	85.0	10.0	10	30.1	5.0
(ii)	6	6.0	85.0	2.0	10	21.2	3.5
(iii)	3	3.0	85.0	10.0	10	26.1	8.7
(iv)	12	12.0	85.0	10.0	10	37.9	3.2

cost of default, the loss of funds, is related to the amount of loans provided (L_{at}). It is assumed that a bank makes provisions in year t proportionally to the volume of loans provided in that year. Later, when defaults on loans issued in year t appear, they can be written off against these provisions. The effect of default on all cost components (the term 1/1-d) is related to loan volume (L_{vt}), as interest payments in year t must cover all costs in that year. Administrative costs can be divided into fixed cost (A_{ft}) and variable cost (A_{vt}), the latter related to the number of loans. Of course, in the long run all costs are variable, but the distinction is useful as banks have a tendency to operate with a considerable amount of fixed costs for staff and building. Rural banks are usually branch offices, and the cost resulting from supervision and guidance from the main office can be either stated as a separate term in the denominator (A_{ot}), or included in the fixed and variable administration costs. Formula (1) can now be rewritten as Formula (2):

Formula (2): lending costs in year t = $[(L_{vt} * c/u)+(L_{at} * d)+(L_{nt} \times A_{vt})+ A_{ft} + A_{ot}]/[L_{vt} * (1\text{-}d)]$

This formula expresses lending costs as the interest rate on loans required to cover all expenditures. The interest rate is expressed per period, and this period is the same as the one defining the loan volume.

The data required in this formula are usually contained in a bank's annual accounts. In case distinctly different lending services are provided, seasonal loans and investment loans for example, it is worthwhile to separate the costs per type of service. Below lending costs and other parameters for short-term lending by 42 saving and credit groups functioning as small rural bank branches in West Java in 1985 are presented in Table 2. The actual lending costs for 1985 were:

$(L_v \times c/u) + (L_a \times d) + (L_n \times A_v) + A_f + A_o = 11.7 + 38.4 + 7.1 + 17.3 + 11.3 = 85.8$ Rp million

These costs were to be covered by revenue from the interest rate charged on the loan volume in that year by those repaying their loans:

lending cost = actual costs / $[L_v \times (1\text{-}d)]$ = 85.8 Rp million / (2348 Rp millionmonth x 0.902) = 4.1 percent per month.

With formula (2) the impact of changes in loan volume on lending cost can be demonstrated, as shown in Figure 3. The graph shows the lending cost for a range between plus and minus 50 percent of the actual loan volume; fixed costs and default rate are assumed to be stable for this range. The interest rates covering lending costs corresponding to the extremes are 3.6 percent and 5.4 percent per month respectively. In this situation the difference is vital as the actual interest charged was 5 percent per month, being the maximum rate permitted by the government. At that rate the volume of loans cannot drop below Rp1,400 millionmonth for the bank to remain profitable.

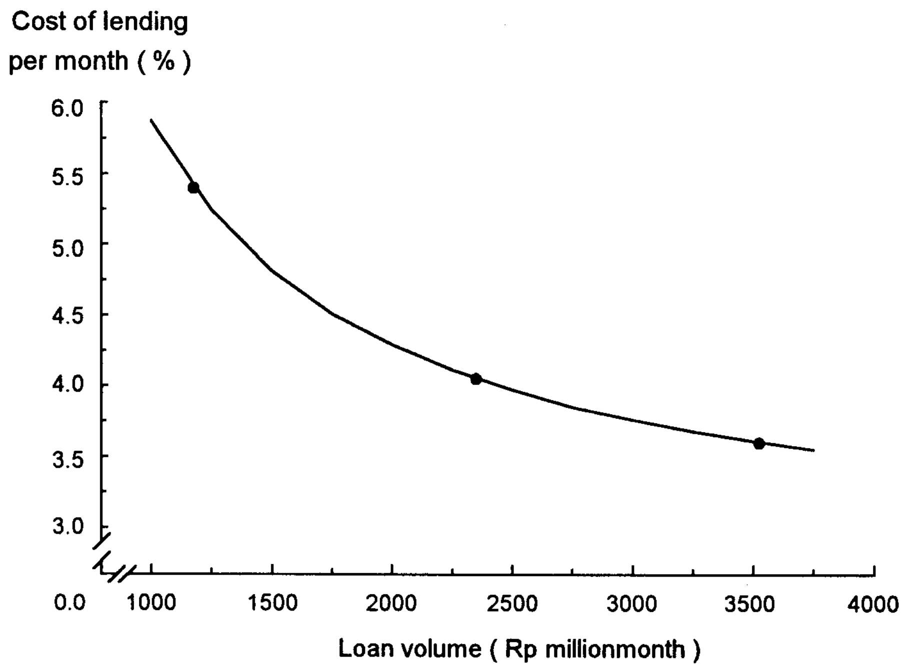
Incorporation of lending operations enables the formula to link actual and possible values for lending parameters to bank profitability. The formula can be used to estimate additional costs of new lending operations and the interest rate required to cover these costs given various assumptions about loan volume expected.

Table 2: Lending Costs and Other Parameters of 42 Saving and Credit Groups in West-Java (1985)

Lending parameters		
loan volume	(L_v)	2348 Rp millionmonth
amount of loans issued per year	(L_a)	393 Rp million
number of loans issued per year	(L_n)	4352
Administrative costs, variable	(A_v)	1630 Rp/loan
Administative costs, fixed	(A_f)	17.3 Rp million
Administrative costs, central level	(A_o)	11.3 Rp million
Default rate	(d)	0.098
Fund cost	(c)	0.004 per month
Fund utilization	(u)	0.80

Source: Moll 1989.

Figure 3: Relationship Between Loan Volume and Lending Cost



The Framework for Evaluating Rural Banks

The expanded lending cost formula must be applied within a comprehensive perspective on actual and potential bank performance. A multitude of factors affects performance. Some are under control of the bank, others are not. The factors under the bank's control can be grouped under three main headings: organizational structure, method of operation, and services offered. Decisions taken in these three fields determine the supply of financial services. Factors not under the bank's control are those governing the demand for financial services: the number, location and financial capacity of actual and potential clients.

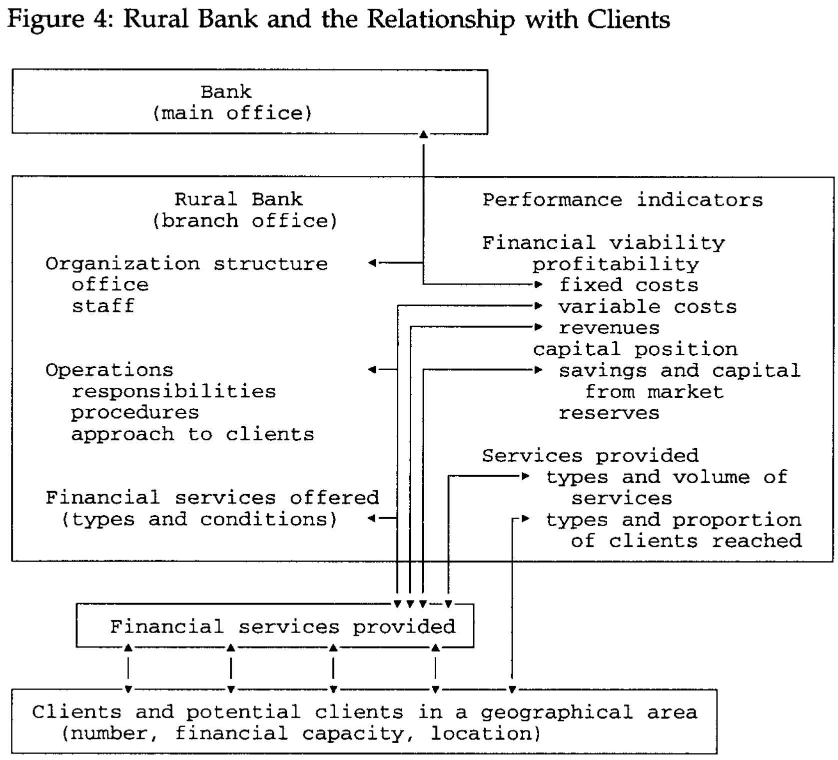
The relationship between a bank and its clients is expressed in the financial services provided. Therefore, the logical performance indicator for banks with the objective of providing financial services to more rural households consists of the types and volume of financial services provided over time. For analytical purposes, type, volume and time aspects can be separated into two operational performance indicators: (1) the types and volume of financial services provided in a particular year, and (2) the bank's financial viability in that particular year as a proxy for the bank's ability to offer these services in the future.

Financial viability has two aspects: profitability, or the balance between revenues and costs as stated in the profit and loss account; and the capital position which reflects the ability to attract capital and the ability to cover anticipated and unanticipated losses through reserves. Profitability and capital position are usually stated in the bank's financial statements.

The main factors in the supply of and demand for financial services and the performance indicators for the harmonization of supply and demand are brought together in Figure 4. The figure depicts the rural bank as a branch office. The three main fields of the bank's policy decisions are organization, operations and services offered. These affect the cost structure through fixed costs for building and staff, and through variable costs determined by the volume of financial services provided to and accepted by the rural population. The effects on financial viability of possible changes in a bank's policies in these three fields can be studied by combining expected values for parameters affected by policy changes with actual values for the other parameters in the formula. Formula (2) covers lending cost only, and revenues must be calculated separately to determine the hypothetical impact on earnings. Policy changes that affect the volume of savings involve costs and revenues and the capital position of the bank.

The effect of existing policies or changes in these policies on the second performance indicator, the volume and types of services provided, can be stated in absolute or in relative terms. The first is directly available and an increase over the years shows a bank's ability to reach a growing number of clients with appropriate services. Relative performance, in the sense of reaching a certain proportion of rural households, requires data on the number, location and financial capacity of all potential clients. This requires research and thus involves costs, but the results of this research would give direction to attempts to extend the volume of services to the types of clients to be reached and types of services to be offered.

Figure 4: Rural Bank and the Relationship with Clients



Policies regarding the three main fields of bank decision making -- organization structure, operations and services offered -- and the two performance indicators -- qualitative and quantitative -- offer a comprehensive framework for the analysis of a bank's performance. This framework can be used by rural banks to analyze their present situation and the effects of possible policy changes. It can also be used by researchers to analyze experiments to determine the feasibility of innovative organization structures and methods of operation aimed at providing formal financial services to small rural clients, such as, group loans within a two-tier financial organization, mobile savings and credit units, mobile credit officers, and various types of specialized, more or less formal institutions operating at low costs. Comprehensive analysis with attention to all components of the framework and elaboration of the details of the innovative experiments will contribute to better insights into the possibilities and limitations of rural banks to serve the poor and to realize financial sustainability at the same time.

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6

A Changing Financial Landscape: The Evolution of Finance Policy in Indonesia

Ross H. McLeod

If we review the literature of the 1970s, it is possible to discern two strands which have been very influential in the formulation of policies towards the financial sector of LDC economies. The first is a degree of antipathy to informal finance, exemplified by Rozental's complaint that:

> [Moneylenders in the unorganized sector] create a pattern of interest rates which weigh heavily on those least able to bear the explicit or imputed costs of borrowing ... they perpetuate forms of behaviour not conducive to social discipline and responsibility (Rozental 1970: 18).

The second is the notion that economic development can be encouraged by promoting financial development. This was presumably the intent of the ILO's recommendation that:

> ... the total scale of financial resources in the organized sector must be greatly expanded so that those who are at present using the unorganized system, and those who have had to rely on self-finance, can be accommodated (ILO 1974: 242).

Both these views suffered from tunnel vision. Those who criticized informal finance either were not aware of, or simply chose to ignore, the wide variety of financing arrangements which characterized it -- preferring instead to think in terms of the harsh moneylender stereotype. They complained about "exorbitant" interest rates, but failed to consider the actual costs of lending—the high transactions costs inherent in small-scale loans, the costs of additional services sometimes provided by lenders (including risk-sharing, in some cases), and the often high probability of default. Most important of all, they paid little attention to the fact that the ubiquity of informal finance was strong evidence of its value to those who used it. The inappropriateness of this stereotype has since clearly been demonstrated by numerous studies of informal finance (see, for example, Adams and Fitchett 1992).

At the same time, those calling for the expansion of resources allocated to formal finance either did so with the intention of having it displace informal finance (in line with this antipathetic attitude), or else virtually ignored the existence of the latter. The second approach may be seen as having been influenced by empirical and theoretical work which had been done on the relationship between financial development and economic growth[1], which focused largely if not entirely on the expansion of formal financial institutions and transactions without looking at informal finance at all -- as though financial institutions were being set up where previously there had been a vacuum. On the contrary, however, informal finance presumably has been a feature of economic transactions ever since production began to evolve from pure subsistence, and it remains an important aspect of even the most advanced economies.

The historical growth of the well developed formal financial sector observed in the now more advanced countries was a response to the progressive emergence of opportunities for doing things which informal finance could not do as well, most frequently as a result of the steadily increasing scale of business enterprise in general. Often it was a by-product of the supply of services other than financial intermediation. For example, formal commercial banking can trace its origins to informal systems within which well-reputed individuals (usually traders or merchants) would accept cash deposits from others for safekeeping, and could issue hand-written notes allowing their own suppliers and acquaintances to obtain cash or goods on credit from third parties. When the demand for such services became large enough, it became profitable to establish distinct enterprises -- namely banks -- specifically for these purposes.

Likewise, modern day stock exchanges evolved from very modest beginnings, in the form of informal meetings between the owners of shares in various enterprises who from time to time were desirous of changing the composition of their portfolios. Insurance companies and pension funds emerged to provide forms of cover against certain risks faced by enterprises and individuals, which were an improvement on protection available

1. See, for example, Goldsmith (1969), Gurley and Shaw (1955), Gurley (1967) and Patrick (1966).

through informal insurance arrangements. In the case of banks, insurance companies and pension funds, the organizations concerned gained access to large quantities of funds which they were able to invest, making possible huge financial flows in various forms. In turn, the very size of these transfers brought with it a demand for efficient capital and money markets in which they could be transacted.

The Role of Formal Finance

The appropriate role for formal finance, therefore, is to complement, not supplant, the informal sector -- or at least, only supplant it to the extent it is better able to compete. As the economy evolves, individual incomes rise and medium and large-scale business activities begin to proliferate, and the resultant emerging demands for financial services of all kinds create opportunities for setting up specialized formal financial institutions. But to the extent that the pre-existing demands of low-income households and small-scale business activity remain, it is a mistake to imagine that these new institutions are able to serve these kinds of need better than what had been accomplished previously under informal arrangements.

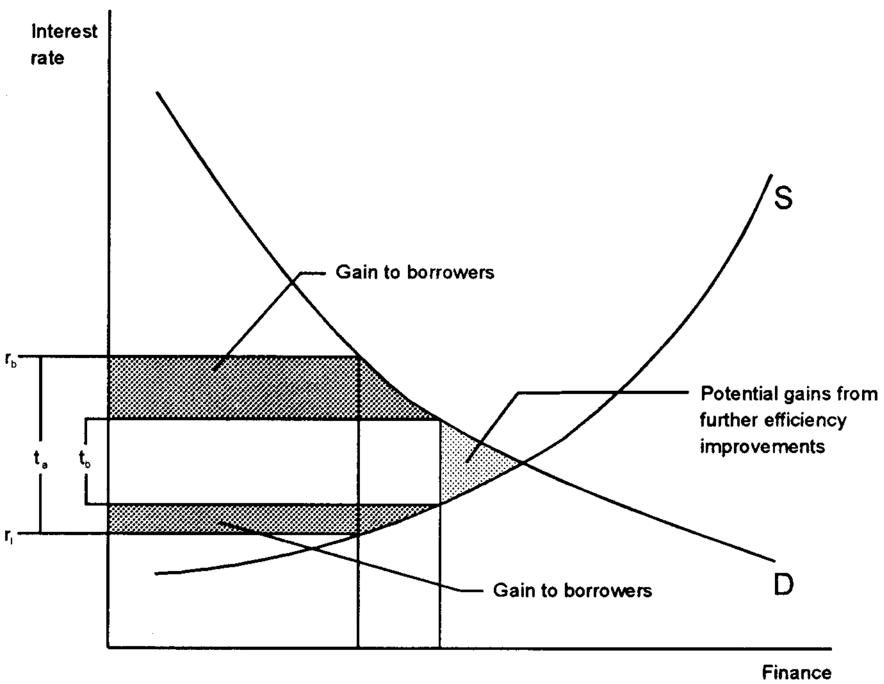
Thus, for example, the frequent complaints about banks not being interested in the financing of small businesses and farmers are misguided. As the writer has argued elsewhere, banks simply are not good at competing for this kind of business (McLeod 1991: 208-209). That these complaints are made is a reflection of the notion that formal finance should supplant informal. On the contrary, what banks should be doing is simply what they are good at doing.

The broad focus of sensible policy in respect of the financial sector can be illustrated very easily using a simple welfare economics analysis of the financial market (Figure 1). At all times, there are entities wanting to lend funds and those wanting to borrow. In the absence of transactions costs, an equilibrium interest rate would be found which would equate the supply (S) of, and demand (D) for, finance. In reality, transactions costs drive a wedge between interest paid (r_b) and interest received (r_l). Financial intermediaries (*qua* intermediaries) owe their existence to these transactions costs: they are firms set up with the intention of reducing these costs (from t_a to t_b) -- which in the general case is beneficial to players on both sides of the market (as indicated by the gains in buyers' and sellers' surplus).

In the absence of evidence that interest rates are distorted, the job of governments is simply to do all they can to ensure that different intermediaries and different techniques of financing are able to compete on an even footing, and to provide a legal and regulatory environment conducive to the smooth working of financial transactions. This policy will lead to the discovery of the best ways of transferring funds between surplus and deficit spending units, and generate the greatest welfare gains to lenders and borrowers alike.

It is interesting to note that, in reality, a characteristic of official finance policy has been to focus on the finance markets as serving investment and savings needs alone. But borrowing may be undertaken for

Figure 1: Gains from Reduced Transactions Costs



consumption purposes as well, and lending may result from entities' decisions to restructure their asset portfolios, not just to increase their saving (e.g. to sell some rice or farm animals and bank the proceeds). Thus I have been careful to avoid attributing the supply schedule in Figure 1 to "savers", and the demand schedule to "investors". It should be emphasized that the welfare gains in the diagram are just as real if the borrower uses the proceeds for consumption, and if the lender simply wants to substitute financial for real assets. A great deal of energy is wasted trying to ensure that loans are used only for productive purposes (that is, for investment).[2]

The investment focus of finance policy reflects the fact that such policy has always tended to have a very simple growth model as its basis, rather than the more sophisticated welfare economics approach. The growth model sees growth being determined by investment: growth is good, therefore investment is good. More investment is better than less. Low interest rates are good because they encourage more investment. The welfare economics approach warns us that, taken to its extreme, this argument would have people using all of current output for investment, leaving them with zero consumption. In reality, a trade-off always needs to be made between consuming now and consuming later (saving), which is encompassed in the welfare economics approach.

Historical Background to Finance Policy in Indonesia

We have already discussed the ideas about finance policy in developing countries which were prominent in the literature of the 1960s and early 1970s. It will be helpful to add to this a brief discussion of some important aspects of the historical background more specific to Indonesia. At the time Indonesia became independent, those who suddenly found themselves in the position of economic policymakers had little appreciation for the usefulness of markets. The spirit of the times is captured in Indonesia's Constitution, which contains references to fundamental principles such as "just humanity" and "social justice for all the people". It calls for the economy to be "built up as a joint effort, based on family principles" (interpreted to mean a preference for cooperatives rather than self-interested private enterprise), for "branches of production important to the State and those which control the necessities of life for the masses" to be controlled by the State, and for "land and waters and the natural resources contained therein" to be controlled by the State for the greatest good of the people. In all this is evident a fundamental distrust of market forces and private enterprise, with which the term "capitalism" was regarded as synonymous.

This distrust of capitalism derived from Indonesia's colonial past, which those who fought for independence and who framed the new Constitution perceived as a period of gross exploitation. Although "capitalism" took the blame, however, it was through the denial of economic freedoms by the colonial government[3] that the people were able to be exploited, not market forces and private enterprise. This misconception had the unfortunate effect of starting economic policy-making in the newly independent Indonesia in a direction in which state enterprises were set up (or foreign firms nationalized) in strategic sectors such as banking, competition amongst enterprises was seen as unnecessary or harmful, and planners tried to take over from markets in determining the allocation of productive resources in the economy.

An additional factor reinforcing negative attitudes to markets was the presence of a small ethnic Chinese population within Indonesian society. The Dutch had used the Chinese as an economic buffer between themselves and the indigenous population, allowing them considerable freedom to practice and refine their entrepreneurial skills, while *pribumi* (indigenous Indonesians) were largely restricted to manual work in agriculture, manufacturing, construction and other sectors. The ethnic Chinese came to occupy an economically dominant position in the towns and cities, and thus to become the object of considerable resentment. Again, it was easy to blame the market mechanism and the pursuit of self-interest through business enterprise for this state of affairs, adding weight to arguments in favor of extensive government control of the economy, direct involvement of the state in production of goods and services, and support for cooperatives and the "economically weak group", that is, indigenously owned small businesses.

In short, there was a good deal of support both within government and on the part of the general public for the kind of finance policy discussed in the introductory section. Moreover, the resources with which to boost the role of the formal finance sector became available with the first OPEC oil boom in 1973. Suddenly, Indonesia's balance of payments shifted into surplus, while government revenues were swelled by the large

2. It is virtually impossible to succeed in this attempt at quarantine in any case, since enterprise owners spend both for investment and consumption purposes. Borrowing increases total spending power, but there is no way of knowing whether this is used to increase investment expenditure alone.
3. Such as restricting choice of occupation, access to schooling, and freedom to compete across the full range of economic activities, and by heavy taxation in kind of farmers.

increase in oil sector taxes. In this environment, it was hardly surprising that Indonesia's policymakers set about an ambitious program designed to terminate the supposed dependence of small businesses, farmers, fishermen and the like, on self-finance and informal finance.

Aspects of Earlier Finance Policy

With these comments as background, we turn now to discuss some of the more significant aspects of finance policy in Indonesia. It should be stressed that there has been something of a revolution in these policies in the last decade. These changes, and the reasons for them, will be discussed subsequently. This initial commentary, therefore, refers to the 1970s and early 1980s.

Repressing Informal Finance

Unlicensed, that is, informal moneylending is illegal in Indonesia. This is inherently difficult to enforce, however, so moneylending goes on regardless. The government has a legal monopoly on one particular form of moneylending: namely, pawnbroking. Private sector pawnbroking also goes on, nevertheless (Bouman and Moll 1992: 218-219). As well, there is a very close informal substitute in Indonesia's countless gold shops, where people from all walks of life may both purchase and sell jewelry or ingots. The gold shops are effectively part of the informal finance sector. From the point of view of the saver, they don't provide deposit services, but they facilitate saving in the form of gold, by guaranteeing to repurchase gold at current market buying rates when savers want to "make a withdrawal", that is, when they need liquidity. Looking at this from the opposite point of view, the gold shop will buy gold and guarantee to resell it at the current market selling price when the borrower is no longer short of funds.[4] For the latter, the effect is just as if he had pawned some of his possessions in order to obtain a loan. The popularity of gold shops is just one example of the ability of informal finance to find ways around official constraints placed upon it.

Boosting the Formal Sector

Perhaps Indonesia's most famous example of the idea of boosting financial development by channelling resources into the formal finance sector has been the creation of a highly dispersed rural infrastructure of (eventually) some 3,600 village units of the state-owned smallholders' bank (Bank Rakyat Indonesia, BRI), to service the needs of farmers and the rural population generally. This was part of a larger package (*Bimas*) designed to boost Indonesia's rice production to the level of self-sufficiency, involving the use of high yield rice varieties and agro-chemicals (fertilizer, pesticides, etc). The inputs were supplied on credit at a very low interest rate, with loans to be repaid to BRI. In turn, BRI's portfolio of *Bimas* loans was refinanced in its entirety by the central bank, at an even lower interest rate.

The story has been told in detail elsewhere (see, for example, Patten and Rosengard 1991: 58n; Schmit 1991: 102n). It is doubtful the finance part of the package was essential. The subsidy provided by way of cheap finance simply added to that contained in the supply of seed and chemical inputs below cost, and could therefore have been substituted -- at an enormous saving by dispensing with the entire village unit network of BRI -- by a higher subsidy on these other inputs.[5] Why did the government not choose simply to distribute seeds, fertilizers and the like at lower prices (through private sector middlemen and/or the cooperatives) and leave the farmers to borrow funds for these purchases if necessary in the informal market? The reason was, presumably, either a failure to appreciate the existence of the informal finance market, or the desire to drive out informal financing of smallholder agriculture. Whatever the case, the scheme was financially disastrous because of the high level of defaults, which required a continuously increasing flow of subsidies from the government to BRI.

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4. The formal markets have refined this practice to make it an extremelyefficient means of dealing with liquidity fluctuations for big players in the finance market. Such entities effectively can borrow large sums at very short notice by selling their holdings of low–risk or risk–free securities (such as government bonds) to another party, with a commitment to repurchase at a later date.
5. If farmers faced an interest rate of, say, 7.5 percent per month in the informal market, then a reduction in the price of the package of material inputs of around 32 percent would have left them just as well off as they would have been with no price reduction, but with the inputs supplied on Bimas credit at 9 percent per annum, assuming the loan has to be repaid after six months, and assuming monthly compounding of informal loans. It would be of great interest to estimate the total cost of this subsidy by comparison with the costs of establishing and staffing BRI's village units, and the cost of borrower defaults.

Also well known in Indonesia was the subsidized loans to small business program, known as KIK/KMKP.[6] Again, the focus was the small borrower, supposedly neglected by formal finance, and left at the mercy of the unscrupulous moneylender. And again, the techniques were much the same: loans were provided at well below market rates, and largely refinanced by the central bank, with the additional feature that the credit risk was insured by a government–owned insurer (PT Askrindo). The major differences from *Bimas* were that the loans were for general, rather than specific, purposes (provided they were used productively), and that borrowers for the most part were selected on an individual rather than a group basis. The scheme was much less disastrous than *Bimas*, but still very much dependent on cheap finance from the central bank to keep it alive.

At the other end of the finance spectrum lay the stock exchange: the epitome of a financially well developed economy. The government went to great lengths to reactivate the Jakarta Stock Exchange -- moribund for years following nationalization of mainly Dutch–owned big businesses in the years after independence (McLeod 1984: 99-103). The most visible signs of its financial commitment were the expensive new stock exchange building, and the large numbers of civil servants transfered to the newly established supervisory agency (Bapepam) and the national investment fund (PT Danareksa); added to this were the various tax concessions offered to induce companies to offer their shares to the public, and the large volume of financial resources put at the disposal of Danareksa. All of this stood in embarrassing contrast to the small number of firms willing to list their stock during the JSE's first decade of existence, and the tiny volume of trading carried out each day.

The difficulty in getting companies to list, despite all the incentives offered, to some extent reflected the importance of informal finance and self–finance. Small and medium enterprises can acquire sufficient equity capital without the need for access through a formal stock exchange to hundreds, even thousands, of individual shareholders. They do so by tapping the resources of the founding individuals or families, by reinvesting profits, and occasionally by taking on an additional major shareholder. Even some very large enterprises and conglomerates prefer to build their capital in this manner. Moreover, the information disclosure requirements that go hand in hand with formal stock exchange listing are a boon to the taxation authorities -- and therefore a strong disincentive to listing. Tightly held, non-listed enterprises are much better able to conceal their profits than those who choose to raise equity capital in the stock market. Likewise, many potential new shareholders prefer to invest in unlisted companies -- including their own -- where the flow of dividends is not readily apparent to others.

The establishment of PT Danareksa, was a rare instance of concern by the authorities for the supply side of the finance market, rather than just the demand side. The intention was that Danareksa would purchase large quantities of shares as they were listed, and then resell them (individually or in combination) in very small bundles to the poor. It is hard to imagine that there was any kind of unfulfilled demand here waiting to be met. Individuals with small amounts of savings available for investment not only had alternative access to the formal finance sector (through bank deposits), but also were able to save in the traditional informal manner, through investment in real assets such as land, housing,[7] farm animals, stocks of rice and, in particular, gold. The purchase of gold jewelry or ingots serves much the same purposes as investment in shares: there is the possibility of capital gain; the asset is liquid (because gold shops will always repurchase gold at the current market price); there is some protection against inflation; requests for (highly risky) loans from family members can be more easily turned down (on the grounds that one has no money available); and the temptation to consume rather than save is more easily resisted if there is no cash in one's pocket or under the mattress. Despite all these avenues for small-scale, informal wealth accumulation, a large sum of money was put up by the government to allow Danareksa to undertake its role as conduit for investment by the poorer members of the community. Predictably, the general public showed virtually no interest, and, with very few listings in which to invest, Danareksa used much of its funding to lend in the lucrative short–term money market.

In summary, from the mid 1970s the government devoted considerable financial, human, and material resources to the objective of supplanting informal finance in the financing of small, medium and large firms. Over more than a decade these efforts achieved very little. Many firms of all sizes continued to prosper and grow, while continuing to rely heavily -- sometimes entirely -- on informal sources of finance, and by carefully economizing on the use of capital (see also McLeod 1991: 198-199).

Financial Repression

Interestingly, at the same time the government was pouring resources into the development of the formal

6. Kredit Investasi Kecil/Kredit Modal Kerja Permanen (Small Investment Loans/Small Permanent Working Capital Loans). The program is discussed in Bolnick (1982 and 1983) and McLeod (1980 and 1983).
7. Investment in housing is an extremely common form in which people save in Indonesia. This does not necessarily refer to the purchase of entire houses, but also -- and more importantly -- to expenditure on small additions and improvements to peoples' own residences.

finance sector, its distrust of the market mechanism had led it to hold back that sector's ability to grow in accordance with market demand for its services. Most important were restrictions on bank entry and branching. No new banks had been permitted to be established since 1971 -- although this of itself may not have been of great significance, since there were scores of private domestic banks in addition to the seven large state banks, 27 provincial government banks, and 11 foreign banks. But undoubtedly of immense importance was the difficulty banks faced in obtaining official permission to open new branches. Indeed, bearing in mind the popular antipathy to private moneylenders, it is salutary to recall that the government itself was the primary obstacle to the spread of formal sector institutions which might compete with them.

A further factor which held back the provision of high quality banking services to the public was the steady, large-scale flow of loan refinance funds from the central bank to the dominant state-owned commercial banks, and the fact that they also obtained a great deal of funds from "captive" state enterprises (which had to place all their deposits at the state banks). On the one hand it could be said that this enabled these banks to grow, but on the other, it largely removed their incentive to improve service quality on the deposits side, since they were never short of very cheap funds. The government for some time paid a subsidy on time deposits collected by the state banks, but there was so little incentive to collect such deposits that the subsidy was somewhat ineffective[8]. Likewise, the government designed a savings deposit product, *Tabanas*, to be offered by the state banks, but it was never very effective in mobilizing funds because the banks had little need of them.

While barriers to entry held down the number of banks, and restraint of branching held back the physical spread of banking activities, the government also limited the volume of funds which could be intermediated by the banking system by imposing asset growth limits on banks (in an attempt to control growth of the money supply). In short, at the same time it was trying to boost the role of the banking sector (primarily the state banks), it was also holding back its expansion in other ways.

Besides suppressing growth of the banking industry, official policy during this period also suppressed the price mechanism, thus distorting the signals sent to borrowers and depositors alike. All state bank loans carried below-market interest rates, and most were heavily subsidized by the central bank through the refinance mechanism (Table 1). The pattern of subsidies was extraordinarily complex, with a fine differentiation of borrower rates, refinance proportions and refinance rates across numerous loan classes. All this created an aura of great sophistication in the implementation of finance policy which was entirely spurious. The most extensive and careful economic analysis imaginable would not have been capable of revealing with any degree of confidence the ultimate effects of such a subsidy system on the real activities it was intended to influence. One of the few things which can be said with certainty is that the imposition of low lending rates generated excess demand for loans from the state banks -- a circumstance in which, quite predictably, bribes were both solicited and offered by bank officials and borrowers, respectively. The actual effective cost of subsidized loans to borrowers was therefore much closer to free market rates than their nominal cost would suggest.

Results of Finance Policy to 1983

If indeed the aim was to displace or supplant informal finance, there is little evidence to suggest that this succeeded. There certainly was significant growth of the formal finance sector, but it is a moot point as to whether this brought much gain in terms of increased national income. Moreover, growth may well have been much greater in the absence of entry, branching and asset growth restrictions on banking. It is clear that the policies followed brought about, or exacerbated, various problems -- including poor service to bank customers, corruption, and reduced viability of the state-owned banks. From the equity point of view, it would be difficult to make out a convincing argument that the poor in general have been made any better off by means of finance policy; on the other hand, however, it is quite clear that there have been very significant gains to the owners of the many large firms which were able to obtain access to heavily subsidized loans from the state banks.

New Policies

With the passage of time, the distortions which resulted from official finance policies came to be much better appreciated, leading to several dramatic changes in the policy regime over the last decade -- changes which were unimaginable to the writer right up to the time at which they began to make their appearance[9]. The most significant were introduced through two major packages of banking deregulation, one in June 1983 and the

8. This policy had been highly successful in an earlier period (the late 1960s), when Indonesia was emerging from a period of hyperinflation. See Cole and Slade 1992: 79-80.
9. See McLeod 1984: 106-108. The writer's prediction of "more of the same" for financial sector policy could hardly have been less accurate!

Table 1: State Bank Lending Rates and Subsidies (prior to August 1982)

Group	*Short-Term Credits (up to One Year)*	*Investment Credits (over One Year)*	*p*[a]	*d*[b]	*n*[c]1
1	Supply and distribution of rice, paddy and corn by cooperatives		1.00	3	9.0
2	Special agricultural programs		1.00	3	12.0
3		KIK, KI (up to Rp75m)	0.80	3	10.5
4	Salt, wheat and flour Smallholders' agriculture, animal husbandry, poultry farming, fisheries and handicrafts Exports and production of export goods Aid financed imports, distribution of food and commodities Production, import and distribution of fertilizers and insecticides for use by smallholders	KMKP[d] KI (Rp75m-Rp200m)	0.75	4	12.0
5		KI (Rp200m-Rp500m)	0.70	4	13.5
6		KI (Rp500m-Rp1500m)	0.65	4	13.5
7	Manufacturing, service rendering, sugar stock Domestic trade, imports and distribution of supervised goods Contractors to public sector		0.70	6	13.5
8	Contractors to private sector		0.60	6	13.5
9	Imports and distribution of other import goods		0.40	6	18.0
10	Others (not included elsewhere)		0.25	6	21.0

[a] p = refinance proportion
[b] d = refinance rate (% p.a.)
[c] n = lending rate (% p.a.)
[d] KI = Kredit Investasi (investment loan); KIK = Kredit Investasi Kecil (small investment loan); KMKP = Kredit Modal Kerja Permanen (permanent working capital loan)

other in October 1988. There also have been some other less significant new policy packages, while a set of new laws relating to banking, insurance and pension funds were enacted early in 1992. Broadly speaking, the thrust of these packages shows that the government has become far more willing to rely on markets and the private sector to determine financial flows and the terms on which they take place, and indeed for guiding the structural evolution of this sector.

Banking Deregulation Packages

The 1983 package put an end to most controls on interest rates at the state banks. A few special subsidized lending programs remained, as did the interest rate control on *Tabanas* savings deposits. Controls on the volume of bank lending, which had not been an effective means of managing monetary growth, were also discontinued at this time (McLeod 1993: 120-121). This package had a significant impact on the banking sector. The state banks had been warned they would need to become self-reliant from the point of view of funding, and they reacted by increasing their time deposit rates very substantially. Private sector banks were obliged to follow suit in order to maintain their market share. Total banking sector assets grew very rapidly as a result.

The 1988 package was more significant for its impact on institutional development. Barriers to entry in banking were removed, for all practical purposes. This resulted in a more than doubling of the number of private domestic banks to 139 by September 1992, and an increase of 19 new foreign joint venture banks, compared with 11 previously. At the same time, it has become very easy to obtain permission to open new branches, with the result that bank branches and smaller offices are springing up everywhere: the number has gone from 1,728 in December 1988 to 4,407 in September 1992, with the private sector banks -- which had only 593 offices in 1988 -- accounting for over 2,276 of the increase. (This is a good indication of the harm that was done by suppressing branching in earlier years.) Furthermore, there have been about 770 new, mainly privately-owned, secondary banks[10] (*Bank Perkreditan Rakyat*, BPR) established in this period.

One of the most important changes implicit in these new finance policies is the apparent retreat from the belief that better results can be achieved through the use of state-owned enterprises rather than private ones (at least, in banking). Whereas the process of privatization -- as the term is usually interpreted -- has not made an appearance, Indonesia in fact has taken a different route to the same destination. It has been prepared to see the state banks fall back in terms of market share, in the belief that the private banks actually have more to offer. *De facto* privatization of the banking sector is being achieved simply by allowing more or less equal competition amongst banks, including BPRs.

The government has not been prepared to increase the capital of the state banks to anything like the degree that private sector capitalization has increased over the last decade. Based on balance sheet data published by the central bank (Bank Indonesia), shareholders' funds of the private domestic banks grew at an average annual compound rate of about 42 percent in the 10 years to March 1992, compared with only 15 percent at the state banks. The latter in fact have had a substantial injection of equity from the government more recently, to help them meet the new capital adequacy standards currently being phased in. It seems highly unlikely that this will be repeated, however. Without further equity injections, and in the absence of high profits, growth is constrained by the need to maintain an appropriate balance between the size of the asset portfolio and the size of capital available to absorb potential losses. Accordingly, the state banks will only be able to keep pace with the private sector banks if they can achieve much higher profitability in the future.

Abandonment of Bimas and KIK/KMKP Lending

Other important changes to banking policy of interest here include the abandonment of the *Bimas* loan program at the end of 1983 and of the KIK/KMKP program in early 1990. This does not indicate that the government no longer has any interest in the demand for financial services on the part of smallholders and small businesses, but rather, that it sees more effective ways of catering to these demands.

In the case of *Bimas* loans, operational losses -- and the subsidy required to keep the implementing bank, BRI, afloat -- had simply become unsustainable by 1983 (Patten and Rosengard 1991: 64). Nevertheless, the bank by now had a very extensive network of village units, which between them employed around 14,000 staff. Rather than turn away from this enormous investment in infrastructure and human resources, BRI set about designing and introducing new banking products capable of generating profits which would justify the continued maintenance of this investment. The first was a lending product, *Kupedes*, which differed from *Bimas* loans in several important respects. It was a general purpose loan, in recognition of the fact that a large and growing proportion of the rural population are not farmers (and that not all farmers grow only rice). It was provided on an individual, not group, basis, allowing the bank to select only those borrowers it believed to be good credit risks. (By contrast, selection of borrower groups for *Bimas* was largely out of the hands of the bank; this contributed heavily to the very high level of defaults.) Most important, the lending rate was far higher -- about 33 percent per annum, by comparison with 9 percent with *Bimas*. The new lending rate is still well below rates in the informal market, but has proved sufficiently high to make the product profitable to BRI without any need for subsidy. In turn, this has provided a strong incentive to the bank itself to strive for rapid expansion of *Kupedes* lending. *Kupedes* loans outstanding grew from Rp111 billion to Rp846 billion in the five years to December 1989 (Patten and Rosengard 1991: 77).

It was already beginning to be appreciated in the mid 1980s that the supply side of the rural banking market had been much neglected. People in rural areas have a desire to save, and in the absence of bank branches they are forced to rely mainly on the accumulation of cash, gold, livestock, agricultural produce and so on. All such options have their own disadvantages -- such as the possibility of loss or theft, damage to, and deterioration of, stocks of produce, and the need to spend time on management of livestock. The existence of reasonably accessible banks offering attractive deposit services overcomes these kinds of disadvantage. Such services are especially valuable to the poorer segment of the rural population, whose low and often intermittent income makes it important to have liquid savings to draw upon to meet occasional unpredictable net cash outflows. This group had been almost entirely neglected previously because of the preoccupation of finance policy with the demand side of the market, and within that, with borrowing only for productive purposes. The very poor do not generally own their own land or businesses, so if they borrow at all it is likely to be for purposes of consump-

10. Secondary banks are distinguished from primary, or money–creating, banks, by their exclusion from the check clearing system.

tion (in which, it should be emphasized, are included expenditures on items such as schooling and medical care).

On the basis of these considerations, BRI introduced a savings product, *Simpedes*, to the rural population through its village units. After operating a pilot project for some time in a few units, the product was introduced nationally in 1986, meeting with quick and dramatic success: *Simpedes* deposits grew from just Rp5 billion to Rp700 billion in only four years to December 1989 (Patten and Rosengard 1991: 77). For the first time then, it could be said that Indonesia's rural banking policy had begun to operate along the lines suggested earlier -- that is, encouraging formal finance to compete with informal on more or less equal terms. Clearly, it has been able to compete successfully, using its special advantage over non-bank moneylending and trade credit: namely, the existence of a national branch network allowing genuine intermediation between unconnected surplus and deficit spending units.

The government's approach to the abandonment of the KIK/KMKP program has been quite different from that to its abandonment of *Bimas*, although it can be argued that the objectives are much the same. It simply announced the program's discontinuance and replacement by a requirement that all domestic banks -- not just the state banks which had undertaken the bulk of KIK/KMKP lending hitherto -- should extend sufficient loans to "small" businesses such that the proportion of these loans in their overall loan portfolios should be at least 20 percent. Perhaps the most important aspect was that such lending was to be on terms and conditions to be decided by the banks themselves. Important also was the definition of "small", which effectively allowed the inclusion of loans to much larger businesses than would have been covered by the former subsidized program, thus reducing the extent to which formal finance was to be forced to compete with informal in segments of the market where it could not do so profitably. Again, therefore, policy moved far in the direction of free markets and reliance on the private sector, and implicitly acknowledged the value of informal finance to small firms.

Privatizing the Capital Market

In the capital market, too, the emerging preference for markets and a more carefully considered role for government is evident. Privatization of the more orthodox variety has been occurring, first with the government encouraging the establishment of a private stock exchange in Indonesia's second largest city, Surabaya, and more recently with the JSE having been sold to the private sector. The Surabaya exchange seems to be having a hard time competing with that in Jakarta, which underwent a significant growth spurt commencing in 1989. This upsurge in activity seems to have resulted partly from changes in government policy and partly from the appointment of a new head of the capital market supervisory agency, who proved to be a very energetic promoter of the JSE, and who seems to have been able to persuade far more companies than hitherto to "go public". On the investor side, however, there remains considerable doubt as to whether the demand for equities is real, or has merely been propped up by "captive" investors, such as the civil servants' pension fund, PT Taspen.

Protection for Suppliers of Funds

A final aspect of changing finance policy worthy of note has been the shift from official concern in the past with moneylenders as "exploiters" of those who borrow. The new approach recognizes that the greater danger to the public is posed by individuals or organizations which accept deposits or other forms of funds from the public. Whereas those who borrow from moneylenders do so knowing the terms and conditions of the transaction, those who put funds with informal deposit-takers cannot be sure that they will be able to withdraw these funds when they wish to do so, because the other party may simply steal them, gamble them away, or invest them in ventures which fail. The underlying rationale, therefore, for the new regulatory thrust in relation to banking, insurance, pension funds, and the issuance of equities is protection for parties making their funds available for use by other entities.

Why Did Policies Change?

By far the most important influence for change in Indonesia's financial landscape has been the change in official attitudes to the finance sector, and the resulting redirection of policy discussed above. Various factors have contributed to this change. First, the successfulness of several Asian countries following more market-oriented policies, and the difficulties experienced by countries with more heavily interventionist approaches -- including Indonesia -- could not be ignored.[11]

11. It must be emphasized that Indonesia's high growth rate owed much to the running down of its oil reserves.

Second, a central aspect of the government's strategy had been the cultivation of multilateral and bilateral aid, concomitant with which was a high degree of openness to a steady and increasing flow of external advice in many fields, including economics. There is little doubt that the thrust of outside opinion would itself have been moving in the directions of freer markets and greater reliance on the private sector during this period.

Third, fluctuations in the price of oil on the world market have also played an important role. The oil boom of the 1970s largely removed the imperative for sound economic management, and various populist schemes got under way because they were now capable of being financed, not because they had demonstrably high socio-economic returns. But in the 1980s, when it was found that oil prices could fall dramatically as easily as rise, it became much easier for economic rationalism to influence policy.

Finally, a factor which seems to have been overlooked hitherto is the growing confidence of, and in, private enterprise. The private, modern sector of the economy has grown rapidly in both size and scope, to a degree that is clearly apparent to anyone who has watched Indonesia's development over the last decade or two. It can be seen, for example, in the overtaking of agriculture by manufacturing as the larger contributor to GDP, and in the rapid growth of manufactured exports (Hill 1992). An important influence here has been the increasing number of overseas-trained young people returning to Indonesia, bringing with them all manner of skills previously in short supply -- not to mention a strong appreciation for the market mechanism.

Implications for Informal Finance

Highly significant policy changes have been made in the financial sector in Indonesia over the last decade. None of these has directly addressed the informal finance sector; indeed, the only direct connection has been that the new finance sector laws explicitly prohibit the carrying out of banking, insurance and pensions activities except with an appropriate license. (The authorities recently have demonstrated their intention to enforce this prohibition by bringing cases against a number of firms which appear to have been heavily involved in deposit-taking without being licensed.) Nevertheless, the changes which have been made will certainly have significant effects on the informal sector.

This is because the formal and informal sectors both compete with, and complement, each other. To the extent formal finance is constrained, informal finance will find ways around those constraints. If the constraints on formal finance are removed, it will move to take back what it has lost. Thus, for example, the rapid expansion of bank branches and the number of BPRs will put healthy competitive pressure on informal moneylenders. In other ways, however, by giving the formal sector more room to grow, informal finance will be given a boost. More loans to the trading sector -- bread and butter for the banking system -- will enable more trade credit to flow through to small businesses and agriculture than previously. In short, there will be a much better balance between formal and informal sectors, because they will now be forced to compete on their own merits.

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7

Informal Rural Finance: An Aladdin's Lamp of Information[1]

F.J.A. Bouman

Ever since development aid to low-income countries started some forty-odd years ago, policy and research with regard to rural credit have been limited to a one-sided emphasis on the role of formal financial institutions: commercial and nationalized banks, specialized agricultural development agencies set up by the government or international donors, village and regional cooperatives, or projects initiated by private Non-Governmental Organizations at home and abroad (NGOs). Little or no attention has been paid to the potential development role of the informal financial circuit. Informal finance was -- and often still is -- identified with a money market dominated by unscrupulous moneylenders, traders and landlords who were commonly regarded as being anything but development-oriented. The lone researcher who, even in the seventies, submitted a paper on the exploits of informal financial intermediaries to a conference on rural credit, was more or less seen as an eccentric and out of tune with the reality of his time.

In the Brave New World of development co-operation there seemed to be no place for the informal finance sector. Informal finance was considered to belong to an outdated, somewhat archaic subsistence economy, rather than to an optimalizing market economy aiming at increased production to feed the starving millions of the countryside. One did not even speak of an informal financial market -- that term has only recently become popular (Von Pischke 1983) -- but only of "informal lenders", with the emphasis on "lending".

That same emphasis on lending can be noted in the literature on financial services offered by formal institutions. With few exceptions, attention has been paid exclusively to credit, agricultural credit in particular. It is as if the most important part of financial intermediation, that is, the accumulation of savings, has been disregarded completely. Indeed, why should one pay any attention to savings when development workers point out that rural households in low-income countries are too poor even to think of saving? Do not most households produce far too little even to stay alive? And the lucky few who produce a surplus, do they not indulge in wasteful consumption, squandering their money on social, religious and ceremonial expenses at marriages, funerals, harvest festivals and rites of passage during which each tries to outdo the other with expensive clothing, dowries, gold and silver trinkets and indulges in excessive feasts of food and booze? And were not informal lenders only too willing to comply with this propensity to indulgence, to keep their victims in perpetual misery and debt? Missionaries and clergymen had said so (many still do!), colonial administrators, village officials and the occasional travelling dignitary put it in their reports, social workers repeated the theme and suggested the creating of "benevolent societies" and the preaching of thrift as the only possible salvation of the poor. Significantly, Polly Hill speaks in this respect of the inheritance of "the colonial obsession with debt" (Hill 1982: 216), an obsession which is particularly in tune with our times and seems reluctant to die.

This one-sided emphasis on the flow of credit via formal financial channels is based, on the one hand, on the strong belief in the superiority of the formal sector and, on the other hand, on a series of misunderstandings of the nature, magnitude and role of the informal finance sector and the type of actors that dominate in this field.

Superiority of the Formal Finance Sector

Financial services do not consist only of facilitating mutual payments between individuals and firms in order to ensure that everybody receives his salary on time to pay for his daily shopping, his insurance and garage bills. The most important and indispensable task of banks in the economy is financial intermediation. Intermediation between individuals, institutions and regions with a surplus of resources -- consider these savings -- and persons, institutions and regions facing a deficit. Practically every community, at one time or other, has its surplus and deficit households. These surpluses and deficits may not be permanent and often are of a (very) temporary nature. It is the task of financial intermediaries to intermediate between the two.

Rothschild, the famous banker, expressed this in the most simple terms. Banking, or financial intermediation, is nothing else but moving money from point A where it is, to point B where it is needed. Banks are held to be superior to intermediaries in the informal finance sector because they can move money in larger sums and over greater distances at short notice, not only from a city to its neighboring village, but from London to Paris, from Tokyo to Bangladesh and from New York to Zaire and Brazil. Someone once explained to this author the inferiority of the informal sector very eloquently in one sentence: "Moneylenders merely shuffle around local

1. Originally published in *Sociologia Ruralis* 30(1990): 155-173. Reprinted with permission of the editor of the journal.

savings". Banks, on the other hand, shuffle around savings on a global scale. There is a gist of truth and simplicity in this statement although informal lenders of repute, of Indian, Chinese and Lebanese origin, have also succeeded in moving vast sums of money over a considerable distance, as have the tribal associations of Africa.

Further, banks have formed networks that tie them together nationally and internationally so that they can act as clearing centres of information. They are protected by legislation, controlled by a central bank guarding against breaches of monetary policy and supported by the state and the national and international banking community.

Banks dispose not only of much larger amounts of capital than informal financial agents, they can also lend this capital over much longer periods of time. Neither the Suez or Panama Canals, the Aswan Dam or the railways across the United States could have been realized through funding by the informal sector. The village moneylender, trader or pawnbroker may even have problems in financing deep bore wells at farm level, because it involves repayment over several years, and those lenders cannot wait for the return of their capital that long because they need it to finance short-term activities promising quick returns. In short, economists tend to agree that financial intermediation by banks ensures a better (re)allocation of resources in the economy -- although they tend to overlook all too easily the questionable funding of the extravagances of Marcos, Somoza and other dictators of shaky fame, as well as the origins of the present world debt crisis and the recent failures and scandals of many formal financial institutions in the USA and elsewhere.

Many planners and development authorities accept, therefore, the judgement of the Indian Banking Commission of 1972 that the informal finance sector belongs to a situation of underdevelopment and cannot cope with the increasing and sophisticated credit demands of a modern growth economy. Some even argue that, in the course of economic development, informal financiers and loan associations become redundant (Drake 1980: 140).

Misunderstanding the Nature and Role of Informal Finance

A second explanation for the one-sided emphasis on formal credit institutions is due to a number of misunderstandings about the informal sector. The first, and still widely held misunderstanding, is that this sector is the almost exclusive domain of the village moneylender. Like a Dickensian Scrooge he is held to lure innocent victims into his evil web by tempting them with loans for consumption. His interest rates are scandalously high. Further, he is not loath to deceive his victim by adding an extra zero to the amount mentioned on the IOU, signed by the illiterate borrower with a thumb print.

This stereotyped portrayal of the informal lender is, to a large extent, due to ethnic and religious prejudice. The first has to do with the fact that moneylenders of repute always have belonged to ethnic minorities. Jews operated in Christian Europe, the Chinese in Indonesia, Malaysia and Vietnam, Indian Chettiars gained prominence in Ceylon and Burma, Pathans from Persia and Afghanistan in India, while the Lebanese were known and despised in Africa. The stigmatizing of moneylenders and moneychangers appears also in the teachings of most religions. The Bible, Talmud and Koran, Budhism and Hinduism are known to reject morally the earning of money from money.

This is really amazing. After all, money is nothing but a representation of purchasing power. With money, one can buy goods. In commercial business, that is the trade in goods, enormous profits may be made without comment or raising the spectre of usury. One easily accepts that sugar in the neighborhood shop is priced more expensively than in the supermarket. The careless shopper who has just bought a bicycle or radio for $200 at one shop and, on his way home, comes across another where the same item is priced at $100 in a sales campaign, may curse himself for his stupidity of not having obtained prior information on other opportunities. But most probably he will not return to the first shopkeeper to accuse him of exploiting the innocent.

It is different with the financial intermediary who, in fact, is nothing else but a trader in money, buying from savers and selling to borrowers. Financial intermediation keeps the economy going. Private trading in money also keeps the economy going, particularly the economy of the poor -- but somehow it is considered as improper, even reprehensible. It should not be done, except by the accepted institutions such as banks. Even when the latter have repeatedly shown a lack of enthusiasm for and interest in handling the financial affairs of the poor, for which they are ill-equipped. Dealing in money outside the institutional framework all too easily earns the stigma of usury without it becoming clear what usury exactly implies and on what cost/benefit analysis the judgement is based.

While the institutional financial sector trades in large sums of money, the private lender trades in small amounts. From the principle of economies of scale, it follows that the latter is more expensive than the former. While a 100 kg bag of fertilizer may sell at the cooperative or supermarket for $20, the same 100 kg, divided over 100 small parcels of one kg sold for $1.50 each at the local garden centre, will fetch $150 without any customer raising an eyebrow or the suspicion of usury.

Now consider the scenario that is rather popular in reports from development agencies. A poor farmer, eager to earn some extra money to sustain his family, has to borrow money to start his operations (mark the sympathetic tone in which the tale is set!). Early in the morning he obtains a loan of $2 from one of the many moneylenders found at any such market of importance in Asia or Africa. The condition is that the borrower repays $2.20 to the lender in the evening. Immediately the indignant observer points out that this represents an interest rate of 10 percent a day; or 3,650 percent on an annual basis. This is labelled worse than usury, it is a scandalous crime against humanity; and the poor small farmer, as usual, is the victim.

For his two dollars, this victim of usury has bought four watermelons of $0.50 each. He has divided each melon into 10 slices, to be sold at 10 cents a piece. His customers usually also belong to the poorer strata of society -- they may even be fellow petty traders -- who cannot afford to buy a whole melon and have to settle for one slice. When he has sold all 40 pieces, our petty trader has made $4 out of the original $2 loan. This represents a one hundred percent profit in one day. Calculated in annual terms, the figure becomes astronomical. While the trader in money is condemned for his greed and manipulation of the helpless poor, our trader in melons is praised for his enterprising spirit and his concern for his family's welfare. The strange fact remains that this author has seldom come across petty market traders stigmatizing their lenders as Western observers do. On the contrary, many (and female petty traders in West Africa in particular) may even entrust their daily earnings to the moneylender as a reliable depository and also to increase their creditworthiness. They are even prepared to pay, rather than earn interest on their savings! Franda, in his defence of the moneylender, quotes a rural Indian proverb that says that no village is complete without a moneylender, a medical practitioner, a teacher and a stream that does not dry up in the summer -- observing dryly that the moneylender is mentioned first (Franda 1979: 39).

A second misunderstanding that could, in particular, explain the paucity of research studies of the informal finance sector and the weak appetite for such research, is the alleged inaccessibility of this sector to the researcher. The almost complete absence of statistics and basic data on what is going on in the informal finance circuit, is attributed to the reticence of lenders about their business, while their supposed victims would also wisely keep their mouth shut.

Many of these stereotypes and assumptions lead to self-fulfilling prophecies. There is no belief in the saving capacity of the rural population in the Third World. Therefore, there seems little sense in building a savings component into a credit project -- hence the myth continues. The informal sector consists predominantly of unfriendly moneylenders, who are loath to give information. So there is no point in investigating what informal finance is really all about: its size, composition, nature of operation, what part it plays in rural households' budgets and what its potential contribution may be to rural development. And so the ubiquitous moneylender remains the unscrupulous exploiter of the poor.

The general reluctance to put informal finance into its true perspective through dedicated and unbiased research, is in curious contrast to the present lively interest in other areas of the so-called informal spectrum. Small enterprises and home industries operating outside the context of official regulation; the informal labor market; mutual assistance in informal -- that is unregistered -- indigenous associations; informal trade, operating locally and across borders without an official permit; indigenous legal systems that are not in concert with national laws; illegal house building in slums -- all these activities have drawn the attention of field-workers of national and international donor agencies and NGOs. Under the catchy slogan of "small is beautiful", the whole spectrum of the informal culture is put under the microscope of scholars, planners and project designers. The notable exception, however, is the informal financial market.

This apparent paradox is all the more astonishing when both policymakers and administrators readily acknowledge that the great majority of rural households in low-income countries still depend on informal intermediaries for their daily financial needs. How, then, can one truly ignore this dependence by simply labelling it as an archaic relic of an outdated subsistence economy, characteristic of exploitation and misery, and shrug it off as inaccessible to study? Most Third World countries are staking future rural development entirely on a rapid expansion of formal finance institutions in the countryside. It is as if they are saying "yes, we know this dependence is there, but it will pass -- look at what we are doing". But why, then, do the poor so stubbornly refuse to see the light and start to frequent these institutions in droves?

Top-Down Decision Making and Misallocation of Financial Resources

Another consequence of the one-sided emphasis on credit rather than financial intermediation was that project planning, as well as evaluation of results, remained limited to an analysis of the process of lending, that looked mainly at the problems and peculiarities of lending institutions. Much less, if any, attention was paid to the behavior and peculiarities of savers and borrowers unless in terms of formulating their (supposed) credit needs. Von Pischke (1981) has aptly dubbed this "the credit need creed" of aid agencies.

Planners told the authorities what should be financed: corn in the south, coffee in the north and cotton in the central regions of a country. Politicians determined which target groups were to benefit and how cheaply the credit should be distributed. Project designers then outlined models to calculate the necessary input of money and, above all, the returns the project would generate. The latter -- in professional economic jargon "the internal rate of return" -- usually predicted a bonanza for the country's economy and the target group. Officially, the small farmer was always to be the main beneficiary. *Ex post* evaluation, however, indicated with despairing monotony that it was not the large group of small farmers, but a small group of the more affluent who had reaped the benefit of the cheap credit programs.

A first indication of the extent of the misallocation of financial resources by cheap credit programs of the formal sector came with the publication of the *Spring Review of Small Farmer Credit* by the AID in 1973. It contained twenty hefty volumes of evaluation of credit projects in some fifty-odd countries worldwide. This was followed by the publications of Donald (1976), Von Pischke and others (1983), and Adams and others (1984). Adams, in particular, has been the main source of inspiration behind the criticism of conventional cheap credit programs. The experience with credit for small farmers, handled by formal finance institutions, proved to be in direct contradiction to the economists' argument that financial intermediation by banks ensures a better (re)allocation of resources in the economy.

But despite the mounting criticism, researchers and evaluators kept reasoning that it was not the concept of formal lending to the poor that was at fault, but only that the implementation of credit projects needed correction. Procedures and *modus operandi* had been inadequate. As has become habitual in evaluation reports, this resulted in predictable, generalizing "conclusions and recommendations for the future". Procedures should be simplified and speeded up, loan application forms be much smaller and worded in more comprehensible language, criteria for judging creditworthiness less formal. Land as collateral for a loan should be replaced by (future) harvests, individual responsibility for loan repayment by collective responsibility of groups of borrowers, records on loan disbursement and collection should be kept more carefully. And, of course, corruption by officials and interference by politicians in the targeting of beneficiaries should come to an end. Sometimes higher loan interest rates were recommended but quickly rejected because "it would be politically unfeasible to charge higher rates to the poor".

Hence, the situation remained unchanged for a long time. The concept of the moral and technical superiority of the formal over the informal sector in dispensing financial services to the poor remained accepted wisdom, and still little attention was paid to the functioning of the informal rural finance market.

Towards a New Approach to Informal Finance?

A re-thinking of the conventional belief in formal sector credit programs and finance institutions was more or less forced upon the aid agencies with the arrival of the oil crisis. It made donors reconsider their development budgets, while the subsequent worldwide debt crisis brought a new realization of the necessity of generating domestic savings within the developing countries' own economy (Adams 1978; Vogel 1984). Favorable comments on the ubiquitous traditional savings and credit groups, as autonomous self help institutions, by authors like Ardener 1964; Nayar 1973; Bouman 1977; Barton 1979; and Miracle and Cohen 1980 were finally taken seriously. In particular, the savings capacity of rural households through the ROSCA-mechanism gained recognition and became a favorite topic of discussion even among major agencies like FAO and the World Bank.

Today, the same conferences and workshops that earlier seemed almost embarrassed to accept papers on the intricate workings of the informal financial circuit, routinely devote part of their proceedings to a discussion of the merits and demerits of the informal sector. The October 1989 International Seminar on Informal Finance in Washington may have signalled a major breakthrough in the re-thinking of donor agencies (Adams and Fitchett 1992).

It will come none too soon. The informal financial sector is of major importance to the economy and general well-being of precisely the low-income rural households that the aid agencies have been mandated to support.

Let us reconsider two other typical misunderstandings about this sector. Firstly, its representatives are not all that inaccessible to researchers. The Third World is bristling with traditional savings and credit clubs. They enjoy so much popularity among the indigenous population, that migrants have even transplanted them into their new countries. One finds Indonesian *Arisan* and Surinam *Kasmonies* in the Netherlands, *Hui* among Chinese and Vietnamese, and *Ke* societies among Korean migrants in the USA. Ethiopians at the IMF in Washington have been known to conduct their own *Ikub*. All these clubs are of the ROSCA-type.

Boards and members of these associations in low-income countries are often more open and reliable informants than, for instance, officials of politically-dominated village cooperatives. Through the traditional ROSCA and other savings and credit associations, the researcher may also obtain his first information on other informal credit sources such as pawnbrokers, traders, landlords, shopkeepers, produce buyers in agriculture and home industry. He may be directed to financial intermediaries like the professional and non-professional moneylender, indigenous bankers and finance corporations and made aware of the existence of other self-help groups like guilds and similar professional, recreational and religious organizations, burial and social insurance associations. Even particulars of private lending and borrowing arrangements between relatives, friends and neighbors may be easier to obtain than information from bankers, who are bound to secrecy when it comes to discussing the financial details of their account holders.

The collection of statistics, bookkeeping data, financial records and baseline data from the past certainly poses problems, because the nature and volume of one's financial and business affairs will always remain a delicate subject. But even as authoritative an author as Barbara Harriss notes that the suspicion and reticence of the informal financial intermediaries disappear once they become aware that their visitor is an unbiased and knowledgeable expert, familiar with the intricate nature and subtleties of the informal market, is not working for the government and speaks the local language (Harriss 1981: 228).

Of equal importance is the fact that a study of the many traditional types of self-help societies moves the attention away from the customary fixation on credit and loans. Members of these clubs are lenders as well as borrowers and alternate between savings and credit positions (Bouman 1977: 182). Attending the weekly or monthly meetings of such a society -the dedicated researcher is advised to become a member himself -- provides the opportunity of interviewing members in familiar surroundings and among friends. This makes it easier to obtain a more intimate and accurate view of the daily routine of life, the determinants of behavior of the small saver and borrower, and the rationale behind his actions; the form in which he/she prefers to save and why; what modus belongs to each different savings purpose (one may save individually or prefer the discipline of group savings) and where or with whom savings are deposited (avoidance of formal institutions is symptomatic of the view rural households have of these institutions!); what his/her priorities are in consumption, investment and social security (investment in a child's education is very popular in many countries); what credit sources are used in varying situations and life cycle events, for what reasons and with what past results.

These and others are fundamental issues that the standard evaluations of formal credit programs have never touched, because they are based on standard donor assumptions about the all-important credit needs of rural households.

Adapting to the Characteristics of a Penny Economy

Human behavior reflects the efforts of the individual to adjust himself to his surroundings. It is therefore imperative that researchers and aid agencies observe and analyze the most critical factors in that environment. Two characteristics seem to dominate the environment of the poor: small-scale transactions and risk. Rural economies, especially in densely populated Asia, are "penny economies" in which almost everything is small scale. Participants in this penny economy produce, exchange, buy and sell, save and borrow and earn money in extremely small quantities and amounts. The market is "atomized": rice is sold not in bags but in cigarette tins; bananas and carrots not in bunches or bundles, but by the piece; eggs and cigarettes are bought singly, and sugar is bought in lumps rather than by the kilo. People save in cents and dimes, not in dollars and women save in handfuls of rice kept back from daily meals. Hence, money transactions in this economy, although very frequent, are mini-sized, too; one does not borrow or lend for long, but for extremely short periods, and interest is calculated on a daily, weekly or monthly but seldom on an annual basis.

The mini-character of rural economies has its consequences for development strategies and intervention mechanisms. Viable financial intermediation in such an environment requires a low-cost institution, making a sufficiently large number of profitable mini-loans to cover overheads, the cost of capital accumulation and the risk of default. Do formal finance institutions fit these requirements?

The formal sector's superiority over the informal one is not in doubt when it comes to financing large-scale economic development and projects of national or regional importance. It can command much more capital and afford long-term loans. But the design and cost structure of most formal finance institutions are such, that they resemble the proverbial white elephant when they try to serve a penny economy rather than a dollar or maxi-economy. Transaction and management costs of banks, in particular, could threaten their survival, because the economy of low-income rural households cannot generate sufficient business volume to sustain them.

Recent research in the Sangli District, Maharashtra State, India, disclosed that the costly construction of irrigation facilities and sugar factories was -- and, indeed, had to be -- financed by banks and government-sponsored development agencies. But the very nature of these official and bureaucratic institutions made them too rigid, unwieldy, top-heavy and, above all, too expensive to provide a flexible and adequate response to meet the many small loan demands. These demands followed in the wake of the economic expansion and diversification resulting from the large-scale investments. Bank staff were already overburdened, handling the highly detailed sector and scheme-wise allocations of the District's annual plans for the eradication of rural poverty. These plans outlined the officially-recognized priority sectors. Loan demands outside the purview of these sectors were simply disregarded, like those for commerce, transport, distributive trade and consumer finance. In particular, loans that involved small sums of money, which have never been popular with banks, were ignored (Bouman 1989: 114-115).

Loans for micro enterprises such as workshops to cast and polish (spare) parts of a pump set, to make chalks for blackboards, to mould plastic bottles, caps and T-pieces for electrical conduits, credit for iron ploughs and sickles, small repairs of pump sets, wells and irrigation pipelines, loans for starting a small shop, jaggery[2], petty trade or a street stall for the sale of fruit, drinks and cane juice, the purchase of a bicycle, refrigerator or TV-set -- all these were largely financed by the informal sector. From the experience in Sangli, it is clear that informal is not synonymous with a situation of underdevelopment, nor typical of a subsistence economy. It is more accurate to state that informal befits smallness, just as formal befits big business. The informal finance sector in Sangli proved far from archaic and outdated, but very much alive, versatile, inventive, and responding more quickly and adequately than the formal sector to changes in the economic environment. It could do so because the informal sector is the natural environment for rural people who are, as it were, born into this sector. "This brings with it frequent face to face contacts, cultural affinity, and a great ability to adapt to the conditions of rural life. Unlike formal institutions, informal intermediaries do not need government subsidies to operate in a rural penny economy. They survive on the basis of competitiveness, financial viability and low-cost operations" (Bouman 1989: 9).

Dispelling a Second Myth

A second important characteristic of the environment of the poor is risk and uncertainty. The best way to combat both, and protect oneself against calamities of illness, drought, floods, harvest failure and loss of income is by taking refuge in insurance mechanisms and spreading of risk. To do so, people have no other option but to form collective networks of mutual assistance, to which to turn in times of need.

It is a fallacy to regard the informal financial market as the exclusive domain of the village moneylender. He forms only a small, often minor part of the protective network of mutual assistance that is chameleon-like and kaleidoscopic in nature, catering to every taste, purse and preference. Not only family, friends, neighbors and tribal age groups are part of the network, but also the local shopkeeper, miller, produce buyer, pawnbroker, trader, landlord, teacher, owner of the fishing boat, fellow farmers and artisans and even the moneylender himself. Further, the network also encompasses the many self-help societies mentioned earlier. In the poor man's world there is not just one moneylender, there are dozens of them.

This network changes continually, in response to the challenges of new directions in the economy and the social fabric of society. With economic growth, it increases rather than diminishes in size and scope. The Scrooges of yesteryear have been replaced by a large number of newcomers: the owner of a tobacco barn in Sri Lanka, distributing seedlings and fertilizer on credit to farmers in order to utilize fully the drying capacity of his shed; the milk collector in India, advancing loans for the purchase of buffaloes to increase his market share of the milk that he sells to the dairy plant; the catering woman, preparing daily lunches for factory workers in Sri Lanka who gets paid when one of her customers wins the ROSCA-fund of which she herself is the organizer; the treasurer of the football club in Nigeria, the female dance group in Cameroon, the debating society in Kenya -- even the administrator of the fund of burial societies. Where money is scarce, it would be unwise to leave it idle.

Further, a new class of part-time petty moneylenders has emerged, like the minor government official, teacher and clerk in North Arcot (Harriss 1981: 166) or the foreman of the sugar and agricultural machinery factories in Sangli (Bouman 1989: 89) and the secretaries of village cooperatives all having the advantage of a regular monthly income. Simultaneously, the *modus operandi* of lending is adapted to the peculiarities of local opportunity. At one of the more favorite tourist spots in Bali, the author met a photographer who had borrowed his camera from the owner on a kind of sharing basis, customary in agriculture, fisheries and cattle-breeding. He paid the owner on the basis of the number of photos made; naturally, the owner also supplied the films in order to keep track of the photographer's business. These examples are novel illustrations of the ingenuity and versatility of the informal finance market. Of course, such arrangements can only work on a basis of confidence -- but is that not the essence of any credit relationship?

Close study of the financial behavior of low-income rural households has refuted other stereotypes and prejudices. The poor are not only eager and regular savers, they also have a great need of safe deposit facilities and ways and means to shed liquidity. A person usually starts the savings process individually and at home. But soon, the saver starts to feel uneasy. He knows too well the almost daily temptations of attractive consumption alternatives that he has hitherto avoided. Then there is always the possibility of theft, fire or another calamity like a local riot (one only has to bear in mind the explosive situations in Sri Lanka and Kashmir). But above all,

2. A traditional-technology plant to extract brown sugar from cane.

he fears the potential claims of prying relatives on his accumulated "riches", once it becomes known that he has some extra funds at his disposal.

To shed liquidity, he has several options. He may deposit his savings with a trusted person or institution; he may start to invest, for instance, in building material for house construction such as stones, cement, iron roof sheets stored in the yard at home (the unfinished houses, even bare foundations, noted in so many African villages are a silent testimony of this illiquidity preference); he may join a traditional savings and credit association that offers the added advantage of compulsory group savings; or he may start to save in debt claims. An example of the latter is the farmer leaving part of the proceeds of his crop with a produce buyer, or a laborer requesting his employer to let his wages accumulate until further notice.

And of course -- and this is in particular valid for Asia -- he or she may save in gold, jewelry or precious stones. Economists may see the hoarding of gold and valuables as a waste of productive resources that is detrimental to economic growth and prefer saving in financial assets and deposits with banks for a better allocation of resources. But people have compelling reasons to prefer gold and jewelry over money (cf. Bouman and Houtman 1988: 73). A very important one is inflation, the steady devaluation of a country's currency, compared to the spectacular rise in the price of gold in the seventies. A saver with a bank deposit of one million Rupees in Indonesia in 1950 (approx. US$150.000) would be almost a pauper in 1990, that same sum now representing about US$500 (excluding interest earnings). Investment in gold, however, would have made him a millionaire many times over.

What is remarkable in these arrangements is that moneylenders, traders, landlords, shopkeepers, even pawnbrokers, precisely the ruffians in the conventional characterization of the "ugly moneylender", often act as trustees and custodians of money, savings and valuables. One other reason why villagers turn to these intermediaries is to build up creditworthiness and establish a reputation of reliability against future loans.

This is not meant as an eulogy of the indigenous moneylender or the informal finance market. Exploitation of the poor has occurred in the past and continues in the present and in specific situations. Excesses occur in any occupation, including the formal financial sector.

Interest Rates in the Informal Finance Market

Much informal credit does not carry an excessively high rate of interest, sometimes it bears no interest at all. Fernando (1986) estimates that more than half of the informal credit in Sri Lanka is cheaper than the loans of the formal circuit. Frequently the lender himself has a vested interest in extending interest-free credit to customers, as in above examples of the owner of a tobacco barn in Sri Lanka or the milk collector in India. The costs of lending are born by the lender as part of the total cost structure of his business. In many cases he would not even be in business without this extra service: the local shopkeeper, the miller, trader and produce buyer, the blacksmith and the owner of a fishing boat are but a few examples. Further, there is the expected reciprocity between parties: *do ut des*, I will help you now and you help me later.

It is also true that high rates do exist, particularly when one is inclined to translate weekly and monthly rates into annual ones, as our economic textbooks do. But these rates are more a consequence of costs and risk factors rather than monopoly positions and exploitation, whatever the case in the past or in specific situations today. Many recent observers of informal credit arrangements voice the same opinion (Harriss 1981; McLeod 1989; Wells 1979; Timberg and Aiyar 1980; Sivakumar 1978; all quoted in Bouman 1989: 60-70).

It is a matter of fact that the poor all over the world pay highest prices, because of their penny-economies of scale. They buy and borrow in the smallest of quantities and represent the greatest risk. In this respect the popular slogan "small is beautiful" is one of the most tragic misnomers in the jargon of development assistance. It is curious to observe that staff of NGOs and other development agencies refuse to accept the logic of loan interest rates of 3 to 10 percent a month, while most people in Third World countries do. Even financial arrangements between friends and family members, and in traditional savings and credit societies, carry such rates. And the latter are supposed to be examples of self-help and humane forms of cooperation and reciprocity! Surely, then, there must be a reason for these supposedly high rates of interest other than exploitation, monopoly and power structures?

An Appeal for Unbiased and Novel Research

Extensive and unbiased empirical research into the magnitude and true nature of the informal finance market in Third World countries has hitherto been hampered by a number of prejudices and stereotyped characterizations of lenders. These have helped to sustain a belief in the moral and technical superiority of the formal finance sector to eradicate rural poverty through a liberal supply of (cheap) credit and rapid expansion of the institutional network in the countryside. The mobilization of savings has become "the forgotten half of rural finance" (Vogel 1984); rural households in low-income countries were supposedly too poor to save and lacked the true spirit of thrift. The many reported failures of this one-sided credit policy in actually reaching the poor and improving their lot have, however, sparked little interest in the performance of the informal finance market and its potentially positive role in fostering rural growth and welfare. Conventional development wisdom still holds that the informal market is dominated by a selfish type of village moneylender -- again that emphasis on lending! -- who is more interested in a stagnant than a thriving rural economy and prefers to preserve the *status quo*. Further, it is generally thought that the informal finance market is inaccessible to the researcher because both lenders and borrowers in this market would have a vested interest in remaining silent about its operations.

This paper has tried to analyze and refute some of the more damaging myths and stereotypes that influence the mind and actions of policymakers, donor organizations and researchers. Traditionally, rural communities have taken care of their own financial needs. To insure themselves against risk and the uncertainty of seasonal cash flows in a hostile environment, people have woven around themselves a protective network of mutual assistance, in which saving, borrowing and lending are daily routine and almost any person, group or organization -- and not only the proverbial village moneylender of ill repute -- can act as custodian or lender of money or goods. This network contains numerous formulae of financial intermediation of great variety, complexity and scope. Its importance to the well-being, even survival, of low-income households in a rural penny economy should not be underestimated. It responds remarkably well to short-term financing opportunities and allows access to services not available elsewhere and at relatively low cost. It can do so because the informal sector is the natural environment for rural people, into which they are born and brought up. Contrary to formal sector finance, the informal circuit is able to respond quickly to the challenges of new directions in the economy and changes in the social fabric of society.

Besides risk and uncertainty there is another important characteristic of the environment of the poor that conditions financial intermediation: its small scale. The poor participate in a penny economy that can hardly generate sufficient business to sustain an expensive institutional network. Unfortunately, the culture of formal financial institutions, used to dealing with the demands of a maxi- rather than a mini-economy, is such, that intermediation between lender and borrower carries with it very high transaction costs for both parties. Organizers of formal credit programs for the poor have found it hard to adapt to the complex financial demands of a penny economy. Informal financial intermediaries have more flexibility.

It is strange, though, that despite the supposed superiority of the formal finance sector for fostering rural development, policymakers and development agents agree that a large majority of rural households in low-income countries still depends on the informal market for its daily financial needs. Is it not then high time to shed prejudices, ignore unproven stereotypes and start a serious investigation into the saving as well as lending and borrowing behavior of participants in that market and explore the rationale of their actions? "If we want to make our assistance more effective in strengthening the economy of the poor, we should start where some of the roots of the problem lie, that is, within our own organizations and within our own minds where we tend to cherish ideas and assumptions which may provide legitimacy to our work, help secure the survival of our own organizations, but prohibit a consistent approach to self-help promotion among the rural poor" (Verhagen 1990: 25). A critical examination of the assumptions upon which earlier development efforts have been based may eventually lead us to admit that many of the accepted wisdoms in our economic textbooks are not applicable to the penny economies of the rural poor -- and may therefore need revision.

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8

Lending to Micro Enterprises Through NGOs in the Philippines

Prabhu B. Ghate

This chapter deals with NGO programs of lending to micro enterprises in the Philippines. It contains four sections: a brief background on the programs themselves, the premises underlying them, questions of sustainability, and some research priorities. The programs discussed represent a major attempt underway in the Philippines to reconstruct the nature of the financial landscapes by using NGOs and "peoples organizations" as intermediaries to make a major dent on poverty by lending to micro enterprises. The term micro-enterprise program refers to the promotion of small self-employment activities through the provision of credit, training and other inputs. Two types of approaches will be briefly described in this chapter: the first approach is to concentrate on qualitative change of a limited number of enterprises, offering them a rather comprehensive range of services. The second approach, that refers to so-called "minimalist programs", is directed at expansion of a large number of enterprises through the provision of a minimum of services.

NGOs and peoples organizations such as cooperatives and credit unions are usually regarded as semi-formal. Although regulated in certain aspects they retain the essential informality of the informal sector. Thus the programs discussed in this paper can be viewed as an attempt to develop and use the semi-formal sector to fill a void left not only by the formal, but also by the informal sector, which practices its own form of credit rationing. To the extent the informal sector does lend to micro enterprises, these programs can also be viewed as an attempt to improve the terms of such lending, by providing stronger competition to the informal sector.

There is a long history of NGO involvement in livelihood programs in the Philippines, based originally on grant assistance from bilateral donors, international NGOs, and even the private corporate sector (through the Philippine Business for Social Progress.) However, in the 1980s government agencies also became increasingly involved through direct lending to beneficiaries. The most salient of the earlier government programs was the KKK launched in 1981. It fell into some disrepute when it became overly politicized in the selection of beneficiaries and had a very low repayment rate.

The Philippines has recently undertaken a major devolution of functions and resources to the local governments under the Local Government Code. However, the interests of the poor are expected to be better protected in future local-government implemented programs by the statutorily granted representation of NGO representatives on provincial and municipal governments (of unto 25 percent of the strength of their legislative bodies).

Livelihood programs were revived under the Aquino administration as a major component of the anti-poverty program and proliferated until as many as 154 programs, according to one count, were being run by nine line-agencies, some of them lending directly to borrowers. Together with several government financial institutions and corporations also financing livelihood programs, they are reported to have been spending P2.3 billion a year[1], of which 40 percent was foreign funded. While various agencies attempted to specialize in their clientele, in practice there was a large measure of overlap, and possibilities of complementation and exploiting economies of scale remained unutilized. One evaluation of several programs being run by different bureaus of the same agency, the Department of Labour and Employment (DOLE), found that most of the programs had the same sort of beneficiaries and were too small to be cost-effective (Bot 1990). On an average, a loan of P10,000 had generated about P23,000 of income a year, as well as 0.9 jobs, divided almost equally between self and wage employment. About one third of the projects financed were a main source of income for the household. There was a close relationship between the success of the enterprise and the repayment rate. Overall the payment rate was 68 percent, although less than 20 percent of the enterprises failed entirely, 15 percent earning insufficient income to make full repayment. There was no observable association between the success rate and the size of the loan. Trading enterprises were on average more profitable than manufacturing and services, and "agro-industrial" enterprises (such as hog-raising) the least profitable.

In response to growing unease with some of the problems of the program, and in keeping with the new (1986) constitution that required the state "to encourage non-governmental and community-base sectoral organizations", as well as with the medium-term development plan (1987-92) which recognized NGOs as "essential partners in the development effort", a decision was taken that by the end of 1989 all line-agencies should discontinue direct lending and channel future assistance through financial institutions or NGOs. At the

1. 25 Philippine pesos is approximately 1 US dollar (1993).

same time a large number of the smaller programs were merged with each other (for example, the various programs under DOLE into the DOLE Integrated Livelihood Program, or DILP). NEDA, the planning agency, became the coordinating and monitoring agency at the national level, through its Subcommittee on Livelihood. However, in 1992 there were still reported to be 56 programs in existence, and data on annual flows, target beneficiaries, lending terms and repayment rates remained hard to come by. The greater decentralization of the program and use of NGOs, cooperatives and credit unions as conduits has, it anything, made the monitoring task more difficult. NEDA has initiated a review of livelihood programs to come up with a new policy framework, and a series of comprehensive evaluations of individual programs has been initiated, similar to that of the DILP.

One of the larger livelihood programs was the *Tulong sa Tao* being run by the Department of Trade and Industry (DTI), which was assisted with an initial loan of US$8 million by the Asian Development Bank (ADB) in 1988 for the first NGO Micro-Credit Project. Utilization was much faster than anticipated, and a second loan of US$30 million was released to DTI in 1991. About 20,000 beneficiaries were assisted through the first loan, through about 200 NGOs, with typical loan size being 10,000 to 15,000 pesos (US$400 to 600) and 61 percent of the borrowers women.

Finally, it is worth noting that the channeling of funds for the expansion of micro-enterprise programs through NGOs and cooperatives is not linkage building in the usual sense of linking the formal financial sector with the informal, or in this case the semi-formal sector. The funds in this case come mostly from government and aid agencies, bilateral and multilateral. Indeed one of the major issues with these programs is whether they can be taken over by the formal financial sector, a question we will return to below in connection with sustainability.

An interesting question is what explains the general shift in emphasis from financing crop production in the sixties to financing urban micro enterprises in the eighties (see also Adams and Von Pischke, chapter 9). The answer has partly to do with the growing realization of the importance of the urban informal sector and the extent of urban as well as rural poverty. In the Philippines, however, the bulk of livelihood program activity is in the rural areas and small towns. Even for households whose main source of income is crop production, fishing or wage labor, non-farm activities constitute a vital supplementary source of income.

The Premises of Finance for Micro-Enterprise Development

Some of the premises are the same as for lending to the poor for other purposes: the poor are not in a position to offer collateral, or collateral-substitutes such as guarantees or interlinkage arrangements, and the transactions costs of non-collateral based lending are so high as to make the poor “non-bankable”. It is not feasible or desirable to force the banks to lend to such borrowers, at least on the requisite scale. While the poor do and can save, it will take them too long to accumulate the capital required[2]. Most forms of informal credit are themselves rationed to the more creditworthy borrowers, and their rates are too high to sustain at least the longer-gestation productive activities.

The well known “five-six” rate of the Philippines applies to loans of as long as one hundred days to long standing borrowers. Thus, it is rarely 20 percent a day (except for small loans to finance ambulant vendors of highly perishable items such as fish and vegetables), and is usually 20 percent a month for new customers. The effective rates are much higher, of course, because of daily amortizations. Still they do not compare unfavorably with fully collateralized pawnshop loans of 5 to 8 percent per month especially when it is considered the lender is working full time making and collecting small loans. Five-six loans are available, however, only in the urban areas and that too to finance mostly high turnover trading and food-processing activities in which they are common. They are not generally available, however, for the kind of longer gestation livelihood activities such as backyard hog-raising. While friends and relatives, and *Paluwagans* or *Turnohans* (local terms for ROSCAs), do finance these activities (see, for instance, Illo and Polo 1990) not everyone has access to these sources.

There is, in addition, a set of premises specific to livelihood and micro-enterprise programs, and here it becomes important to distinguish between the two, as some are specific to one, and some to the other. The distinction corresponds with the one that has been made in the literature between enterprise expansion on the one hand and enterprise transformation on the other (see Boomgard 1989; Meyer 1991; Malhotra 1992). The enterprise expansion approach attempts to upgrade the productivity or increase the turnover of the multitude of

2. We are all familiar with the arguments against doing so at subsidized interest rates, relating to institutional viability, the discouragement of savings, the circumventing of interest rate controls through the shifting of transactions costs onto poor borrowers anyway, etc. However, not all these arguments apply to directed credit in the form of limited credit quotas to target groups, without subsidies, especially as a temporary measure to foster learning by doing by the banks.

activities in what is often referred to as the survival economy. It emphasizes small improvements for many firms, often providing only credit, which is why the approach is often characterized as being “minimalist”. The enterprise transformation approach on the other hand attempts to lift micro enterprises to a qualitatively higher level of sustainability, setting them on the path of long-term growth and seeking to provide a comprehensive range of services, including credit, training, technical assistance and the inculcation of business skills. Being more staff- and management-intensive it can reach a much smaller number of enterprises, and there is a trade-off therefore between a short-term impact on poverty, mostly through self-employment on the one hand, and longer-term enterprise development, on the other, but for a much smaller number of direct beneficiaries. The smaller number of enterprises developed, however, usually have much greater employment potential in the long run. As Malhotra (1992) puts it the choice is between “whether to assist the poor better to survive, or jump-start the less poor who can be the propellers of growth”.

Another distinction between the two kinds of programs, overlapping with the one above, can be made in terms of what have been called “survival” and “viable” activities, with a tendency for livelihood programs to be directed at assisting (expanding) survival activities, and micro-enterprise programs at a smaller number of potentially “viable” activities (sought to be transformed). In practice, both kinds of programs assist both kinds of activity, just as they “expand” as well as “transform”, whatever their formal name. Thus the distinction consists partly of the conceptual connotations the terms have come to acquire, at least in the Philippines. Broadly speaking, however, micro-enterprise programs will have larger loan limits, will tend to have a higher share of assisted activities in manufacturing, and the emphasis in training will be more on technical and business skills than on “social preparation”. A “survival” activity is said to be one into which the entrepreneur is often pushed for want of more profitable alternatives, whereas she (or he) is attracted, or pulled into a viable activity by considerations of profitability, and is an entrepreneur by choice. In the former case, the activity is often just one of many part-time or seasonal activities undertaken to support family income, whereas in the latter it is often the main source of income. In the former case, very often no skills or very rudimentary skills are involved, so that there are very low entry barriers to the activity and it is overcrowded. In the latter case, considerable experience and skills tend to be involved, which restricts entry. In the former case, net earnings tend to be used for sustenance or survival (hence the term), whereas in the latter there are some savings for expansion, with potential for growth (e.g. seamstresses or tailors moving into garment making).

While the distinction between “survival” and “sustainable” activities can be useful in the descriptive sense, it can be highly misleading if used normatively. Household enterprises are ubiquitous in the Philippines, as they are elsewhere. When the main source of income (agriculture in the rural areas and wage labor in the urban areas) is inadequate to sustain a family above the poverty line, the household enterprises provide a vital supplement. The challenge is to increase the contribution of this supplement. If certain activities (“inferior” goods in economic jargon, with negative income elasticities of demand) are abandoned with the general process of growth, so be it. The effort is to make them more productive as long as they exist. The fact that the surplus from certain types of activities tend not to be reinvested for expansion, is often not an inherent characteristic of that activity but a reflection of the poverty of the entrepreneur.

The premise specific to many (although not all) livelihood programs is that they provide an opportunity to make an immediate impact on poverty by capitalizing the knowledge and skills of the poor. It is useful to quote here from a recent statement by two practitioners and action researchers attempting to replicate a Grameen Bank type project in Malaysia:

> A substantial proportion of them (the poor), say at least 60 percent based on (Project) Ikhtiar’s experience, are keen to improve their level of living, have the necessary local knowledge and skills and are self-disciplined enough to take advantage of a good opportunity... These are the capable rural poor... Many of the rural poor have developed over time survival knowledge and skills that, if capitalized, can result in a rapid and substantial increase in their household incomes ... and can create self-employment virtually immediately... (Gibbons and Kasim 1990).

The general sense of a number of evaluations of similar programs for the assetless poor around the world is that they are extremely profitable (Bot 1990; Alonzo and Mangahas 1990; Hossain 1988).

One of the most striking aspects of the economics of micro enterprises is the extremely high rates of return frequently encountered. In case after case, the pay-back period ranges from a few days to a few weeks. Usually, the smaller the capitalization required for the type of enterprise, the shorter the pay-back period, and, what comes to the same thing, return on investment without valuing the opportunity cost of labor-time expended. Thus the returns estimated are usually the combined returns to capital, labor and entrepreneurship. This is the case with Bot’s finding that P10,000 of loan capital in DOLE livelihood programs yielded P1,843 of income per month, at least in the short term. Similarly, Alonzo (1990) found that average net income was 33 percent a month on the value of assets employed (net of land and buildings) in the informal sector in Metro Manila. Sulit

(1990) compared the income and expenditure of 30 women borrowers of *Ahon Sa Hirap*, a Grameen-like NGO, before and after borrowing, and found that average household monthly income went up by 33 percent, and the women's share of it from 32 to 47 percent.

Gibbons and Kasim (1990) are realistic enough to caution, however, that there remains a substantial minority of rural poor in Peninsular Malaysia, say about 40 percent, for whom credit on reasonable terms is not enough to eliminate poverty. They refer to these as the "less capable" poor who need extension, training and expert supervision to pull them out of poverty.[3] If the less capable poor tend also to be the poorest of the poor, and if the typical beneficiaries of the enterprise transformation approach discussed above are the "near" poor, as is usually the case, there would seem to be a need for non-credit inputs at both ends of the poverty spectrum. Moreover, for NGOs with these target groups as their clientele, efforts to tap and "pull down" existing government-provided support services, or fill gaps in them themselves, would appear to promise very high returns.

A large number of livelihood programs operate in the Philippines on the premise, however, that the dearth of credit is the only or at least the major constraint to poverty alleviation, which leads them to their "minimalist" orientation. Prominent among these are the Grameen Bank (GB) replication projects of which there are almost two dozen now. The Grameen Bank does, however, strongly emphasize social preparation through intensive training as well as credit.

The first few projects were started by NGOs in 1989 (the "pioneer NGOs" as they are referred to) working closely with the Asia Pacific Development Council in Kuala Lumpur as part of an effort to replicate the Grameen bank model in several Asian countries. In 1990 a government agency, the Agriculture Credit Policy Council (ACPC), launched the Grameen Bank Replication Program, funded until recently partly by counterparts funds from the Dutch Rural Development Assistance Program. The two dozen or so ACPC participants (most of which are still very small) consist not only of NGOs but also of credit unions and cooperative rural banks. In all about 12,000 borrowers have been covered by the end of 1992, P4 billion saved (more than 10 percent of the total loans disbursed) and valuable experience gained. The repayment rate was about 95 percent for the ACPC project and ranged from the low to the high nineties for the pioneer NGOs.

Clearly, some activities will be more amenable to the minimalist approach than others, and program content and the mix of activities need to be built up on the basis of a clear understanding of the requirements of each activity and its suitability to the particular target group. Vending, for instance is a class of activities in which credit is a major constraint to expansion and which has very low skill-based barriers to entry. It is for this reason that vending tends to occupy a particularly important place in the lending portfolios of many minimalist programs. However, the technical and extension input requirements of back-yard livestock raising, another activity widespread among the poor, are higher, and it is not clear that these are adequately met.

Concern is sometimes expressed that livelihood programs tend to support vending activities disproportionately to manufacturing, which has higher employment benefits and growth potential. However vending activities may be the only feasible activity open to many of the poor, including in some cases the aged, infirm and disabled who would otherwise be reachable only through social security. It has the advantage that it fits in more easily with unutilized female labor time. One view is that vending activities sharpen entrepreneurial skills and generate product knowledge and marketing know-how, and as such constitute a useful preparatory stage for micro-enterprise programs "proper".

The GB replication projects operate on the further premise that the poor know which activities are best for them, providing for only peer-group review of project proposals at center meetings. Thus the approach is essentially non-interventionist in the choice of activity. This is on the whole appropriate in the absence of a greater understanding of the economics and dynamics of the micro-activities themselves. However, there would seem to be a pressing need to learn more about what goes on inside these black boxes, how profitable they really are and, perhaps most crucial, what their complementary non-credit requirements are.

Sustainability

Two related developments in the last decade have cleared the way to the large-scale use of NGOs and cooperatives as intermediaries for lending to micro enterprises. The first has to do with changes in the willingness and legal ability of these institutions to assume credit risk, a role many of them were new to. Livelihood programs in the past were financed largely by grants or highly subsidized loans, repayable at convenience, if at all. The dole-out mentality engendered is a handicap the program has to contend with today in achieving satisfactory loan repayment rates. In order for NGOs to assume credit risk they must possess legal personality. The number of NGOs registered as foundations with the Securities and Exchange Commission has grown rapidly in recent years to over 21,000, although only an estimated 4,000 of these are developmental NGOs, and even

3. A proportion of these presumably can not be assisted even with these inputs. For the infirm, disabled and aged social security assistance may be the most cost effective, if not only way, of providing income supplements.

fewer are involved in credit activities. Similarly, over 12,000 cooperatives were registered between 1987 and 1992, from less than 4,000 prior to this period.[4]

The other development was the lifting of interest rate restrictions on lending and on deposits in the early eighties. Thus the intermediaries can now recover, in principle at least, the extremely high transaction costs of lending to the poor, and their cost of funds, through interest rate spreads. The first ADB loan, for instance, had DTI lending to NGOs at 7 percent and NGOs on-lending at anything from 12 to 25 percent (which means that the minimum margin was 5 percent). The second loan has raised the rate of interest at which DTI lends to NGOs to 12 percent, which is closer to market rates. There are no restrictions on the on-lending rate, except the general guideline that they should not exceed commercial bank rates. Since commercial banks do not make this type of loan and it can be conjectured that it would be pretty high if they did, this still leaves a large measure of flexibility to the on-lenders. Many NGOs have, in fact, left their nominal rates unchanged in deference to nominal-interest rate illusion, a leaf they have borrowed out of the informal lenders' book, while increasing their effective rates through such devices as charging a service fee which is invariant to the size and duration of the loan. Unfortunately, this serves as an unhealthy incentive to turn over loans too frequently for longer gestation activities with fixed asset investment. Weekly amortization is another frequent practice (although desirable in itself) that greatly increases the effective rate of interest. While it is hard to pinpoint current effective rates, they are clearly below rates of many informal lenders and there is little evidence of consumer resistance setting in.

A more interesting question is what rate NGOs should charge in order to cover their costs, one which most NGOs themselves find hard to answer. Estimates vary from 30 to 60 percent per year, except for credit unions, for which they are much lower. Costs are lower for credit unions because their beneficiaries tend to be much more homogeneous and conveniently located than those of foundation-type NGOs. Most credit unions are either based on public markets or institutions where peer group pressure is much stronger, and where the engagement of collectors who do the rounds of stallholders every week, or payroll deduction, is relatively cheap and easy. Most important, loans are made in a fixed ratio (from two to five) of fixed deposits or shares, which are liable to be forfeited in the event of default, and all members stand to gain from repayment discipline in the form of dividends and patronage refunds. Most credit unions have been functioning viably for many years and are likely to continue to do so after the infusion of DTI funds, although these can create some distortions.

A great deal depends, of course, on the level of beneficiaries the NGO is seeking to assist, which determines whether collateral can be sought. Some NGOs are very flexible about the type of collateral they will accept, even utensils, small appliances such as table fans and radios, and fixtures such as wooden shelves. They see this as a way of familiarizing borrowers with the concept of collateral in preparation for when they graduate to banks. The transactions-cost saving advantage of such collateral is not very high. One NGO had a bodega full of such equipment collecting dust. At the other extreme in the cost savings advantage is the insistence by at least one well-known NGO on post-dated cheques as collateral, another instance of mimicry of the informal sector.

Where collateral cannot be sought, NGOs have to put a great deal of effort into social preparation or "value formation" as it is commonly referred to in the Philippines. One of the values sought to be engendered is the obligation to repay, an instance of a collateral-substitute. Week-long training costs for new borrowers followed by a test are particularly high, but seem to be more than offset by the high repayment rate of about 95 percent. Costs also depend on loan disbursement and collection mechanisms, which are minimized through lending to groups organized in centers, following the example of the Grameen Bank. A great deal of further research is needed into what NGO costs actually are under the program, and as important, what they would be were NGOs doing all the things they should to make the credit they provide productive, filling gaps in the support services infrastructure, providing non-credit inputs etc. A program of case studies would be very useful.

The ADB Project Experience

The coverage of operational costs is only one, although the major aspect of sustainability. There is also the requirement that the revolving loan fund available for lending and on-lending does not suffer erosion from defaults in repayment, or through inflation. Defaults can occur at two stages: from borrowers to NGOs and

4. The reasons have to do with the de-politicization of the movement after the Marcos years, but also no doubt with the decision of the Land Bank (the main provider of crop production loans) to get out of retail lending directly to farmers and into wholesale lending only through cooperatives. Thus what is happening on the non-farm side (lending through semi-formal intermediaries) is happening in a much bigger way on the crop production loan side. Land Bank lending has expanded dramatically as a result and fears are being expressed that the country is about to go through boom and bust cycle. The cooperative movement is also split between the old cooperatives and the new, or "government" ones.

from NGOs to the government. In the first ADB loan, for instance, the repayment rate was as high as 85 to 90 percent from beneficiaries to NGOs in the first project and between 97 to 99 percent from NGOs to DTI. However, some NGO repayments had not become due yet, since DTI loans can be for a maximum of five years. The average maturity of NGO loans to borrowers is much shorter, which gives NGOs a chance to turn their loans over from DTI more than once. Since the amortization period of the ADB loan to DTI is the standard soft loan term of 35 years, with a grace period of 10 years, DTI is in a position to revolve the loan for a much longer period. The lending rate of 12 percent is designed to cover both inflation and defaults, apart from DTIs own costs. It will be interesting to see to what it extent it actually does.

It will also be interesting to see how strong the relationship turns out to be between the repayment rate to an NGO and the repayment rate of that particular NGO to DTI. Mismanagement on the part of some NGOs could lead to the diversion of repayments to other activities, not to speak of outright default by "fly-by-night" NGOs, the possibility of which can not be totally discounted in a program as large as this. As a safeguard, and in order to ensure that other NGOs with unsatisfactory loan recovery rates are in a position to absorb the defaults, or in other words that they do in fact bear the credit risk, the program guidelines require an NGO to have a networth of P100,000 and a risk asset to networth ratio of not more than 1:5. In order to encourage the participation of smaller NGOs of high standing, however, the minimum networth criterion can be waived, in which case borrowing by such an NGO under the program is limited to three times its networth. Requirements such as this necessarily entail external audit requirements, and the danger of making it more difficult for NGOs to remain the kind of small, flexible and dynamic institutions which gives them their comparative advantage in reaching the poor. Finding the right balance between prudential concerns and informality is one of the issues the program will have to resolve.

Even if the real value of the funds the program now has at its disposal is preserved, the third crucial aspect of the question of sustainability needs to addressed: where will funds come from in the future for expansion of the program? Expand it must, for two reasons. The first has to do with making a critical minimum impact on poverty. There are over six million families in poverty in the Philippines. Reaching even 10 percent of these, implies a target of about 650,000 borrowers, although it can be assumed at least one million belong to the poorest of the poor, however defined. The other reason is a practical one, and is tied up with the economics of poverty lending. The only hope of covering operational costs at anywhere a reasonable rate of interest is to achieve economies of scale. I will illustrate this with reference to the Grameen bank approach.

The Grameen Bank Approach

Unit costs in the standard Grameen-type operation organized around branches depend in the steady state on the number of field assistants per branch, and on the number of centers per field assistant. A center consists of five to six groups of five borrowers each. The two together yield the number of borrowers per branch. The experience in the Philippines has been that seven field assistants per branch are about optimal. The number of borrowers per field assistant, on the other hand, tends to vary with population density, which determines travel time, and therefore how many centers a field assistant can cover. Given the fixed cost nature of a branch office for the entire operation within a branch, and of field assistants for loans to all borrowers in the centers under the field assistant, Grameen-type operation exhibits strong economies of scale.

Given these economies of scale, unit costs in the start-up and expansion phase depend on the pace of expansion. I believe that it is necessary to set up one or more branches at the very commencement of operations. If the number of centers and groups within centers grows denser with the demonstration effect of a successful program, the cost of a field assistant is spread over an increasing number of loans.

Exercises have been done for the Philippines projecting how many years it would take to reach viability by a GB replication program designed to reach 650,000 borrowers by the end of the century, or about a quarter of the poorest of the poor households with a per capita income below even the subsistence level. The projections assume the adoption of a decentralized model, taking into account the existence of a number of NGOs in the Philippines with valuable accumulated experience of Grameen methodology, the island nature of the Philippines, and the greater risk of things going wrong in a monolithic organization. The projections assume a fairly conservative first-year member strength per branch of only 120 borrowers, building up to 600, 900, 1,400 and 1,500 in subsequent years. Other factors determining viability are loan size, branch salary costs, interest payable on borrowed loan funds for on-lending, the repayment rate, and the interest rate charged to borrowers. The projections assume an average first loan size of P1,500, followed by successive loans of P3,000, P5,000, P7,500, and thereafter P10,000. Salaries are assumed to be at levels competitive with those offered by the rural banks. The interest rate on borrowed funds is assumed to be 10 percent, the repayment rate 90 percent, and interest charged to borrowers a nominal 30 percent. Since repayment is weekly, an average of only half the principal is outstanding over the term of the loan and the effective rate is double. While this may seem high, the largest Grameen project with over 6,000 borrowers, Project Dungannon, is already charging it. It is assumed, moreover, that 20 percent of borrowers drop out at each successive loan after repaying these loans. In order to replace these borrowers, the branches go on recruiting new members to maintain a full complement of 1,500 borrowers.

On these assumptions the program begins to yield a positive net income in the seventh year, and a cash surplus in the eighth, after which it becomes possible for the NGO to start repaying loans in year nine. These projections are very sensitive to assumptions regarding the pace of branch expansion and number of members recruited per branch, which will require validation in the context of further experience. The largest branch in the country so far has about 1,200 members, in Project Dungannon. Operational costs in year one are as high as 470 percent of the loan amount, a reflection of the very small number of members recruited in the first year, but decline to 42 percent in year five and 11 percent by year nine.[5] While they are very approximate, the projections show that a Grameen Bank replication on a large scale can be made viable, and is in a position to repay loans if extended on suitably long terms with adequate grace periods. Moreover, they show that in the standard GB operation with full time staff there is a trade off, or inverse relationship, between the start-up costs the program incurs and the pace at which it expands. The faster it expands and commensurate with loan quality and the training of groups and staff, the lower unit costs and accumulated losses are, and the shorter the period of time it takes for the project to start earning them back.

If loans can not be extended on suitably long grace-periods however, during which operational costs come down to a level that yields cash surpluses, the NGO would need to be supported with grants for the crucial first two to three years while it goes through the painstaking process of social preparation of beneficiaries and training of its own staff. The ACPC-launched GB replication program does, in fact, provide for an operational subsidy for two years limited to half of total operating costs.

There is an alternative approach to replicating the Grameen Bank model which does not rely on the standard branch-based organizational structure, whether the branches are part of a unified “bank” as in Bangladesh, or stand-alone “unit” branches as is being envisaged in the Philippines, and that is to economize on operational costs by utilizing the part-time services of existing staff of NGOs or cooperatives to handle the cash and bookkeeping entailed. Where the overhead represented by the branch manager and senior assistant in the standard Grameen branch can be shared in this way, it becomes possible then to start with less than the full complement of field assistants, and to build their strength up more gradually than recruiting them all in the first year as the macro-projections above assume.

There is a need to experiment with this economizing approach through further action research. The concept essentially is to treat the Grameen Bank approach as an add-on to existing activities, a financial “technology” for reaching the poorest of the poor through group lending, rather than a discrete organization in itself. While it may not be possible to reach the same numbers in as short a period of time, the long-run reach through this approach may be as great, at lower cost.

The approach of the Grameen Bank has made a good start in the Philippines, reaching the poorest of the poor with repayment rates that are much higher than any previous program on a comparable scale, yielding significant increases in household incomes for beneficiaries. However, the movement is constrained from achieving economies of scale because of the shortage of funds. Managers of Grameen Bank-like NGOs spend a disproportionate amount of their time looking for funds, available from bilateral donors, international NGOs and multilaterals, like IFAD.

One way for these managers to save time would be to fund a foundation set up by the Grameen replicators themselves, which would on-lend to qualified replicators, each implementing the program in a decentralized manner to encourage creativity and new approaches. The foundation would charge a service fee to cover its costs which would include those incurred on a strong monitoring, evaluation, and research capability. However, in order to give participating NGOs more room to cover their operational costs, the foundation could on-lend its cheap funds on soft terms to the NGOs[6], instead of it going to the government to cover the exchange risk, as in the case of the ADB-financed micro-credit project loans to DTI. With the benefit of soft loans it should also be possible for the foundation to access commercial loans, and mix them with the soft loans to come up with a composite rate of interest of about 10 percent, the rate used in the projections above. While it would not

5. There have not been any careful studies yet on actual operating costs of Grameen NGOs, partly because they are in a state of flux, attempting to expand coverage of borrowers as fast as possible in order to achieve economies of scale. One estimate, however, of cumulative costs incurred till the end of 1992 for 12 of the ACPC replication projects on which data is available, including program expenditure by the ACPC itself, is about 45 percent of loans disbursed. Some of the better participants, with higher than average repayment rates, rate of expansion of borrowers, and savings, which are ploughed back into the loan fund such as BINHI, had brought operational costs down much faster, to 19 percent in the second year.

6. This strategy is not without dangers. For critical debates on the impact of cheap credit and easy money policies: see Seibel, chapter 2; Adams and Von Pischke, chapter 9; Abugre, chapter 10.

be possible to base the program entirely on loans from the commercial banks, which are not prepared to "wholesale" to NGOs without guarantees, this pooling of commercial and donor funds could be thought of as a weak form of linkage, an intermediate step in the direction of linking the formal and semi-formal financial sectors, the Grameen movement in this case.

It should be possible for the government to agree to direct loans to the foundation if it were not expected to furnish a guarantee. The ADB lends at present to the private sector without government guarantee. Direct lending would entail, of course, the ADB accepting the risk of depreciation of the peso since the loans would have to be denominated in pesos, unlike loans to the private sector. This is a change of policy the donors of soft loan funds would have to agree on. The scheme would have the advantage, however, of pooling the resources of all donors, and of exploiting economies of scale and expertise, while making a direct impact on poverty, which is what soft loan funds are meant for.

Research Issues

As noted earlier, some candidates for high priority research are what goes on inside micro enterprises: how "profitable" they are, what constrains their growth, what are their complementary non-credit requirements, and inside NGOs: what are their real current costs, and potential costs if they were to provide non-credit complementary inputs, how should costs common to several activities, such as social preparation, be apportioned to other benefits, how can NGOs retain their essential informality in the face of requirements laid down in furtherance of prudential considerations?

Some questions with respect to micro enterprises can best be studied by surveys: their distribution across activities; size and pattern of work force, that is, whether single person, family, or employing labor; across age; size in terms of output or turnover; broad sources of finance; complementary patterns of activities within households and so on. Beyond this, as one gets into questions of profitability, when surveys need to be supplemented by careful case-studies using the methods of economic anthropology: use made of the surplus if any (whether partly reinvested or fully utilized by the household), hours actually worked, labor time utilization by different members of the family.

Even strictly "economic" micro-data can only be gathered through such methods, given the problems of recalling intermittent and erratic flows over a period of time. In his study of Manila scavengers Keyes (1982) went round in garbage trucks and observed and measured all the flows from the beginning to the end of the collection chain. Silverio (1982) spent a week each with each of the five *sari-sari* stores he studied. Most researchers have relatives and friends who will give them access to an enterprise. What they often lack is the time. The organizations that need the studies usually need them in a hurry, e.g. for a project preparation report. It would be useful to insulate the kind of research required in this area from the bureaucratic and time pressures of its major consumers.

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9

Micro-Enterprise Credit Programs: Déjà Vu

Dale W Adams and J.D. Von Pischke[1]

Governments and donor agencies are funding an increasing number of programs in low-income countries directed at owners of small businesses, particularly the smallest firms called micro enterprises (Webster 1989; Boomgard 1989). Increased interest in private firms, a belated recognition that many individuals make their livelihood from tiny businesses, U.S. Congressional mandates, and concerns about poor people -- particularly women -- spur these endeavors. Despite differences across programs, loans dominate micro-enterprise projects (Meyer and Nagarajan 1989). As we point out in the following discussion, these micro-enterprise credit programs resemble earlier attempts to assist operators of small farms: both programs involve similar assumptions, both contain similar policies, both tussle with definitional issues, both use the same type of project justification, and, as a result, both are likely to encounter similar problems. Although many micro-enterprise programs are too new for definitive evaluation, a review of earlier small farmer credit schemes may foretell what to expect from this new wave of credit efforts to help poor people.

Credit for Small Farmers

Small farmer credit programs in low-income countries (LICs) have a long history; some programs date back to the early 1900s. After World War II there was a surge in these efforts that accompanied the growth of modern foreign assistance.[2] During the four decades following the war, governments and donors spawned hundreds of small farmer credit projects involving tens of billions of dollars. Most LICs had at least one program, a number of them had multiple programs, while still other countries had a series of endeavors spanning several decades. Most institutions extending loans to farmers under these programs lost money and many of them withered away, disappeared, or were sustained only by recapitalization.

Although institutional arrangements were diverse, many programs were patterned after organizations found in donor countries. The United States, for example, promoted supervised credit programs throughout Latin America that were based on the Farmers' Home Administration. It also promoted rural private banks in the Philippines, in Vietnam, and in Ghana that were similar to U.S. banks. Several European countries exported cooperatives, particularly to Africa, to provide loans to rural people. In other countries, particularly in Asia, governments and donors formed a variety of institutions to provide rural financial services. In a number of countries large donors such as the World Bank and the Inter-American Development Bank promoted specialized rural development banks. Many countries also introduced regulations aimed at forcing banks to lend a larger portion of their loan portfolio to small farmers, either directly or indirectly through development banks.

Common Assumptions

Key assumptions about the status, potential, and behavior of small farmers were virtually identical to the assumptions involved in many recent credit programs for micro-entrepreneurs. In each case the target group was viewed as being too poor to adopt new technologies without formal loans and also being too poor to save. Operators of small farms were thought to need training and technical assistance in order to progress, and it was assumed that appropriate technologies and productive new ideas were available to communicate to them. Promoters argued that informal finance either played little or no positive developmental role, or that it was an evil that should be eliminated; that most of the target group had "credit needs" that commercial bankers refused to fill for reasons that were neither commercial nor economic; and that many of these borrowers would graduate after several years of concessionary assistance and be able to obtain conventional bank loans. Finally, because most of these credit programs were justified on the basis of expected increases in production, project evaluations concentrated on measuring the impact of loans on changes in borrowers' output, income, or employment. The impacts of credit programs on the financial infrastructure were virtually ignored.[3]

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1. Originally published in World Development 10(1992): 1463-1470. Reprinted with permission of the editor of the journal.

2. See Bauer for descriptions of a number of the small farmer credit programs that existed in the early 1950s.

3. An interesting example of this occurred in Jamaica during the 1960s and 1970s where a donor agency funded

Policies

Not surprisingly, common assumptions spawned virtually identical policies and practices in small farmer and micro-enterprise credit. These included loan guarantees to induce banks to lend to target groups, concessionary lines of credit to stimulate targeted lending, subsidized interest rates on loans made to ultimate borrowers, little attention to deposit mobilization, emphasis on making relatively large (and relatively long-term) loans -- sometimes with generous grace periods -- and an almost exclusive reliance on government and donor funds.

Because credit was offered in response to perceived needs, loans funded a large percentage of the cost of investments made by borrowers. Loans were not based on the amount of cash the farmer could reasonably be expected to repay after satisfying more pressing priorities and after the effects of bad agricultural years or other misfortunes that could reasonably be expected to occur. Loan size and repayment terms were usually determined from farm budgets constructed primarily to derive the rate of return from the activity for which the loan was issued. Risk was not reflected in these budgets; normal year assumptions were used. Expected returns were often inflated by optimism that was viewed as more conducive to development than was realism. Micro-enterprise financial models are less oriented to rates of return, but are still largely based on normal year assumptions.

Believers in “credit needs” inevitably view formal loans as being entirely beneficial.[4] It is a curious linguistic twist that the terms “loan” and “credit” carry a positive aura, although “debt” often has a negative connotation. Advocates of special credit programs for operators of small farms or micro enterprises, for example, never propose that imposing more debt on poor people is an appropriate development strategy. Although borrowing may allow entrepreneurs to expand their activities, it puts them into debt, unless loans are grants disguised as credit. Borrowing may allow farmers to expand their activities, but it carries with it an additional cost through exposing them to more risk, including the risk of not being able to repay loans.

Because of the nature of funding sources, there was often pressure in small farmer credit programs to disburse funds quickly and to reward staff on the basis of loans made. It was not uncommon for training and technical assistance, loan approval, and sometimes loan recovery responsibilities to be divided among several agencies. An extension agent, for example, may locate and approve the borrower, an agricultural bank make the loan, and then both parties shared vague responsibilities for recovering the loan. Because of the reticence of private bankers to become involved in political programs, many of these debt programs were implemented by government agencies.[5]

Target Group Definition

These projects were compromised by incomplete loops in the procedures and culture of the institutions designing them. One was a general lack of interest in durability of debtor-creditor relationships. This stood in marked contrast to the intense concern with definition of the target group and the monitoring of disbursements, number of loans made, and their ostensible use by borrowers.[6] Much time was spent in seminars and conferences on small farmer credit attempting to define precisely landless people, peasants, tenants, part-time farmers, small farms, medium-sized farms, and large farms rather than on searching for the characteristics of loan applicants who would use credit productively and repay on schedule.

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a supervised credit program for small farmers that was handled by a government development bank. Various evaluations were done on the program, all reporting highly favorable results, but the bank collapsed because of the excessive costs imposed on it by this and other programs.

4. The “credit need creed” permeated most small farmer credit projects. The creed was based on the assumption that small farmers were poor and that loans were the appropriate treatment for poverty. As a result, loans to small farmers were seldom based on creditworthiness.

5. Occasionally a government-owned bank refused to administer a program that threatened its sustainability. In the early 1960s in Guatemala a donor agency tried to encourage a government-owned bank to charge concessionary interest rates on loans to small farmers. The manager of the bank recognized that these interest rates would not cover the costs of administering the program and refused to lower the rates. As a result the program was transferred to a new agency that was less averse to losing money. Likewise, in Kenya in the 1970s a cooperative bank protected itself by neglecting to make loans under a donor-backed project that involved concessionary loans. Other lenders participating in the project achieved average collection rates of about 30 percent. A third example of this exceptional behavior was the rejection by credit unions in Dominica of a donor-supported project that offered an interest rate spread of 1.5 percent.

6. These issues were extensively discussed during the Spring Review of Small Farmer Credit carried out by the Agency for International Development during 1972-73. A summary of that review is provided by Donald (1976).

Recent discussions of what constitutes a micro enterprise, or a small or medium-sized firm, are reminiscent of those sessions. The quest for precise definitions of smallness is driven by the compulsion to target assistance. But if a micro enterprise is defined as having ten or fewer employees, is a firm that has eleven employees much different? and does the definition have any relevance for the financing of the enterprise? We think it does not.

Project Justifications

What might be called "The Four Standard Deviation Spread" was used to justify numerous small farmer credit projects. It survives today in promotion of many micro-enterprise credit programs. The spread typically began with citations of horror stories about interest rates charged by informal lenders. Recent research is showing that the levels cited were possibly two standard deviations above the norm in informal financial markets.[7] In contrast, the project promoted was typically portrayed as free of any material risks for the lenders who accepted the ultimate loan recovery responsibility. This assumption, in turn, was often far (e.g., two standard deviations) beyond the norm later experienced in these projects. The spread and its widespread acceptance skirted hard questions about creditworthiness and created ample latitude for project designers to ignore the reality faced by borrowers.

In many cases the torrent of farm credit projects outpaced the corps of donor employees who had banking or farm lending experience. Further, many credit projects were dressed up as programs to promote fertilizer use, to boost purchase of machinery, to foster irrigation, to stimulate cattle production, or to diffuse a particular crop or technology. In their heyday, farm credit projects were justified and designed by teams led by a melange of technicians including economists, engineers, livestock specialists, marketing experts, institutional specialists, generalists on a fast career track, and horticulturists. Many of these people had formidable academic qualifications and were experts in their specialties, but they often had little interest or expertise in developing a sustainable and efficient financial system, or in making loans on the basis of creditworthiness.

Accountants were sidelined in this process and few of these projects were fully costed by donors or operated by credit institutions with efficient management information systems. Poor financial housekeeping in agricultural finance institutions was common, and donor records were such that they had no overall view of the financial performance of the projects they supported. Project performance was measured by the number of loans made, tons of fertilizer sold, number of tractors purchased, acres of land irrigated, number of cattle procured with loans, and acres of crops financed by loans. Collection rates of 75 percent on loans to farmers came to be accepted as "satisfactory", and program durability was not a serious objective, except as it could be achieved by repeated donor outlays.

Problems Encountered

Although donor agencies and governments have not yet written -- and to avoid embarrassment may never write -- the final chapter about their experiences with small farmer credit programs over the past 40 years, there is widespread agreement that their strategy was flawed and yielded disappointing results.[8] Most of these programs were transitory and reached only a small percentage of the farmers targeted, who were in turn a minority of the rural population. These programs were unsustainable because they were expensive, collected too little revenue, depended too heavily on outside funding, and often suffered serious default problems. Even worse, a substantial portion of the subsidies passing through these programs, in the form of concessionary interest rates and lax loan recovery, were captured by people who were not poor.

Low interest rate policies distorted the decisions made by financial institutions in two ways. First, the lower the regulated interest rates, the less incentive lenders had to make small loans. Second, these low interest rates on loans depressed the interest rates paid on deposits, which weakened the incentive to deposit funds. Concessionary interest rates on discount lines from central banks further reduced the incentives for retail banks to mobilize deposits in rural areas. This increasingly led financial institutions serving farmers to become highly dependent on donor or government funds. Addiction to outside funds subjected lenders to the whims of governments and donors which, in turn, created ebbs and flows in funding. Attempts to manage this roller-coaster existence, coupled with the rigidities of official institutions, resulted in overstaffing that further boosted the high transaction costs of administering targeted funds. Low interest rates made lenders more responsive to their funding sources than to their loan clients or to depositors.

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7. See Adams and Fitchett (1992) for a recent summary of research on informal finance.
8. On various occasions the authors have been asked to identify successful and sustainable small farmer credit projects. It is humbling to note how short that list is, especially among low-income countries. See Yaron (1992) for a handful of exceptions.

The low quality of services provided by these lenders, combined with the political imperatives that often permeated their operations, led to loan recovery problems that cascaded as programs matured. After a few years the financial problems of the program and the agency handling it typically caused the donors or the government to abandon the scheme. In many cases the financial institution imploded after subsidies were withdrawn and it became clear that its revenues from loans were far less than the costs of operating the program. In sum, few of the specialized agencies handling small farmer credit programs proved to be durable. Their operations were brittle and were seldom able to survive economic shocks in the economy or the onslaught of inflation. Failure became the norm.

Many farmers who participated in these programs "graduated" only in the sense that they returned to self-financing. Few entered the ranks of regular clients of formal lenders. Likewise, most of the "rotating" credit funds set up to support small farmer credit programs failed to make a revolution. They were quickly consumed by loan defaults, by declines in their purchasing power caused by inflation, and by administrative costs that substantially exceeded interest collected on loans.

Lessons

Various lessons can be drawn from small farmer credit schemes that may predict future results of many credit programs for micro enterprises. After all, from the point of view of the financial intermediary, the problems of serving operators of small farms and micro enterprises are similar.[9] The most important of these lessons relate to services offered, credit discipline, loan size, and institutional problems.

Services Offered

1. Lack of funds was not the most important problem faced by most small farmers. Product prices, land tenure, modern input costs and availability, low yields, and risk turned out to be more important factors limiting small farmer development. Yet, credit programs were the most popular response to small farmer problems. It was much easier for donors and governments to create and fund credit programs than it was to address other, more serious problems faced by the rural poor. It may be that operators of micro enterprises also face more important constraints than lack of funds for investments or operating costs.[10]
2. For most small farmers, reliable access to small and short-term loans was more valuable than having large and long-term loans. Many of them were able to fund investments out of equity capital, or through combinations of short-term borrowing, equity capital, and informal loans. Emphasizing small short-term loans may, therefore, be appropriate in credit programs for micro enterprises.
3. Much of the costly technical assistance and training that accompanied loans to small farmers was ineffective. In some cases extension agents had little new appropriate technology to extend and in other cases farmers faced hostile economic environments that eroded the returns from training and technical assistance. For example, no amount of farmer training could overcome an overvalued exchange rate that heavily taxed farm exports. Because of heterogeneity of micro enterprises, is it reasonable to expect that effective technical assistance and training for operators of micro enterprises will be even more difficult and costly to provide.
4. Loan guarantees aimed at inducing commercial bankers to lend more to small farmers typically had little lasting or positive effect. Many banks covered by these programs lent to only a few small farmers for a short time, until they had satisfied their public relations obligations. Most guarantee funds failed to make ends meet and met the same fate as the lenders they were supposed to protect. Loan guarantee programs for micro enterprises are likely to face similar difficulties.
5. Lending to small farmers proved to be costly, even in the most efficient programs. Commercial lenders could not normally cover their costs of lending to these clients, especially when regulations kept interest rates low. Lender transaction costs were highly correlated with loan targeting: the more targeted lending done by lenders, the higher their costs. This in turn led lenders to ration services that were most costly per unit of

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9. Several important differences should also be noted. On the one hand, micro-enterprises typically produce a much wider variety of products and services than do farmers, which compounds the lender's problems of assessing the merits of loans to heterogeneous micro enterprises. On the other hand, micro enterprises are typically located in urban areas, closer to the financial intermediary than are the widely dispersed farmers. As a result, it may be easier for the intermediary to have contact with operators of micro enterprises than it is with farmers.

10. The demand for loans to cover operating expenses may mask managerial or other problems that cause the firm to be short of funds (Kilby, Liedholm and Meyer 1984). Providing the firm with a loan may not solve these more fundamental problems.

money handled -- small loans -- or to become less financially viable. Unless credit programs for micro enterprise are allowed to set interest rates that cover their costs of making small, short-term loans to borrowers with weak credit ratings, they are likely eventually to face similar pressures to ration their services.

Credit Discipline

Loan recovery problems were exacerbated when excessive grace periods were attached to loan repayments, when responsibilities for making and recovering loans were shared by several agencies, when funds for lending carried a political aura, when loans were made in a rush, when loans were given to most people who applied, and when the quality and dependability of financial services were low. New agencies often had more difficulty recovering loans than did experienced lenders, in part because they often emphasized filling quotas rather than making loans in response to creditworthiness. Also, the few programs that stressed deposit mobilization generally recovered a larger proportion of their loans than did agencies relying entirely on outside funds. Micro-enterprise credit programs are likely to face similar loan recovery problems if loans are not carefully made and where deposit mobilization is ignored.

Loan Size

1. Conceived in response to a subjective perception of need, small farmer credit programs -- especially those offering term loans -- often imposed excessive debt on their clients. Relatively large loans funded large changes in technology and scale that exceeded the managerial capacities of borrowers and exposed them to more risks than they were able to manage. Micro-enterprise managerial capacities may be similarly limited.
2. High levels of financing produce large debt service burdens. A bad year can devastate a farmer's repayment capacity, easily putting even the most scrupulous heavily-indebted borrower into arrears. The absence of plans to deal with risk resulted in its poor management by lenders, compounding the costs of improper loan sizing. Micro enterprises also face price and production risks that should be factored into loan decisions.

Institutional Problems

1. Bankrupt or financially weak financial institutions (typically cooperatives, agricultural development banks, or supervised credit agencies) became the hallmark of small farmer credit programs. These lenders were difficult and costly to revive and sanitize once they became stained by political loans and serious loan recovery problems. Talented managers and loan officers shunned them, depositors understandably looked elsewhere, and borrowers felt less obligation to repay an organization that had a reputation for making soft loans. Financial institutions can be debilitated quickly after taking a long time to build. Even more fragility and institutional attrition should be expected in credit programs for micro enterprises because they rely heavily on small non-governmental organizations to handle a large part of the funds lent.
2. Some governments and donors "rolled institutions" as their small farmer credit efforts evolved in a country. They moved their lending programs from one financial institution to another as the results of earlier activities proved disappointing. Most of these programs exhibited few loan default problems in the first couple of years of operation; grace periods, refinancing and long maturities often masked bad loans for a time. As default problems became more apparent, earlier institutional forms were sometimes abandoned, but often the roll simply added new forms. The quest for the institutional form that can defy the "laws of finance" and make and recover large numbers of small loans is likely to continue in micro-enterprise credit.
3. Evaluations of the impact of loans on borrowers turned out to be difficult, ambiguous, and misleading (Adams and Von Pischke 1980). They were complicated by fungibility and costly data requirements (see Feder and others 1990). Studies that compared changes in economic activities between individuals with loans and control groups without loans encountered serious methodological problems. Control groups otherwise identical to borrowing groups would consist of farmers eligible for credit who decided not to borrow -- a rare animal in an institutional environment that converted loans, at least in part, to disguised grants. It was usually impossible to isolate the effects of borrowing because of severe data limitations in studies comparing the before-borrowing and after-borrowing situations. Because donors demanded evaluations to demonstrate whether targeting requirements were met, methodological problems were usually disregarded or down-played. For these reasons, evaluations tended to overestimate program benefits. They concurrently underestimated program costs by ignoring the detrimental impacts of small farmer credit projects on lending institutions, on incentives to save, on the sustainability of financial institutions, and on the damage done to contract enforcement as millions of notes signed by farmers in favor of government agencies were demonstrated to be no more than pieces of paper. Evaluations of many micro-enterprise credit efforts are attempting to measure the same impacts with the same flawed methods.

4. Unsustainable programs were repeated because project design failed to include response mechanisms that would capitalize on experience to correct deficiencies. The absence of self-correcting systems stemmed from preoccupations with disbursing funds and with credit need. It was also a consequence of ignoring the one impact that can be observed relatively clearly in projects for which donors required a separate set of accounts: the impact of projects on the institutions implementing them. Calculating these costs would have provided a foothold for accountability and an incentive to experiment, to control costs, and to build capacity to deal with adversity. Micro-enterprise credit programs face the same problem of capitalizing on experience and documenting the impact of credit projects on the agencies handling them.

Qualifications

Obviously, not all of the hundreds of small farmer credit programs behaved in precisely the same manner. Repayment rates on these projects in Africa, for example, ranged from more than 99 percent to less than 1 percent. Likewise, not all of the hundreds of micro-enterprise credit programs are carbon copies of earlier small farmer credit efforts. In fact, initial collection performance by a number of micro-enterprise credit schemes exceeds that achieved at similar stages in farm credit projects. A few small farmer credit projects performed well in some respects for certain periods of time, including examples in Kenya, Malawi, Morocco, Thailand and elsewhere. But for each of these programs, many more programs soon failed, and some that once worked well later fell victim to predatory behavior by politicians or their clients.

It should also be noted that several of the lessons from small farmer credit efforts have influenced a few micro-enterprise lending programs. One of these is the use of PVOs (private voluntary organizations), also known as non-governmental organizations (NGOs), for project implementation. NGOs can be flexible, and the best of them are problem- and result-oriented because of their values and because their links with donors and governments are as contractors rather than as part of a government establishment. Some NGOs, such as ACCION in Latin America, have been innovative in providing micro-enterprise credit, although it is not yet clear if their projects can become self-sustaining.

A few micro-enterprise credit project designers also are more willing to accept the business decisions made by loan applicants instead of specifying the standard formulas or packages so reminiscent of farm credit. Another innovation is greater reliance on groups, with careful attention to the cement that binds a group together. Groups were sometimes used in farm credit, but these were often ad hoc arrangements formed for the convenience of the lender. There is also recognition in a few micro-enterprise credit projects that highly subsidized interest rates on loans to the poor are dysfunctional and some lip service is given to deposit mobilization. Few managers of micro-enterprise credit programs are game, nevertheless, to charge and pay rates of interest approaching those found in informal financial markets, which probably approximate lenders' and depositors' opportunity costs.

In spite of a few positive features two factors will destroy many micro-enterprise credit projects. The first is uninformed replication: adopting the form of a relatively successful model without a grasp of the substance that animates and sustains it. The second is that any attempt at innovation contains risks, many of which are not apparent at the outset in credit projects. These are viruses that are dormant until a certain stage in a life cycle is reached or a certain shock is received, which causes them to multiply and emerge in virulent strength. They inhabit all innovative institutional arrangements and all credit portfolios. Each variety is programmed to erupt in response to different thresholds and stimuli. Exceptional management and exceedingly well-capitalized financial structures may be required to keep them submerged and to resist their influence.

Conclusions

It is too early to draw firm, empirically-based conclusions about the long-term results of credit programs for micro enterprises, but the similarities between small farmer debt schemes and more recent debt programs for operators of micro enterprises portend similar results. Many of the loans being made to micro enterprises will not be repaid, most of these programs are likely to be transitory, and many of the targeted borrowers will not be materially assisted in the long run through programs that increase their debt.

In our opinion, debt is not an effective tool for helping most poor people enhance their economic condition -- be they operators of small farms or micro enterprises, or poor women. In most cases lack of formal loans is not the most pressing problem faced by these individuals. It must also be recognized that providing financial services to poor people is expensive and building sustainable financial institutions to do this requires patience and a keen eye for costs and risks. Most formal financial institutions in low-income countries currently avoid providing these services for sound commercial reasons, and commercial sources of informal finance are able to offer loans only by charging relatively high interest rates.

Although we are skeptical about credit programs for poor people in general, we also recognize that competitive formal financial systems should naturally expand -- especially on the deposit side -- to serve much larger numbers of these individuals. This can be done on a sustained basis in two ways only: first, financial systems that deal in small transactions efficiently must be developed. Second, innovation is required to assist more poor people to become creditworthy and to have long-term working relationships with formal financial institutions. A barrage of targeted credit programs is unlikely to achieve either.

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10

When Credit Is Not Due: A Critical Evaluation of Donor NGO Experiences with Credit

Charles Abugre[1]

Consider this chapter as a critical assessment of the involvement of operational and donor NGOs with credit activities. It is drawn from ACORD's[2] direct experiences with designing and implementing various micro-credit systems in 10 countries in Africa and through association with several local and international NGOs. Africa is the one place where many foreign NGOs like ACORD still operate directly in the field. Many local NGOs are more or less created by donor NGOs in their own image, or encouraged to serve as conduit for aid funds. Therefore, drawing upon the lessons of ACORD may not only be applicable to other northern donor NGOs, but to many African NGOs as well.

It must be emphasized from the outset, however, that observations in this paper do not represent the totality of ACORD's experiences but only those from which ACORD has drawn its own lessons. Like many development efforts, these lessons are very much the benefit of hindsight -- learning from doing. It is in support of continuous improvement in the learning curve that this paper is directed.

There has been no shortage of conferences on credit within NGO circles over the past few years. In most of these conferences, there has been much discussion about how to improve mechanisms for delivering credit to the poor or, at least improve their access to credit. Fewer have explored how to make the poor "bankable", meaning how to mobilize savings. Fewer still have discussed how and when not to provide credit, or how not to destroy the financial systems of the poor.

It was not long ago that NGOs[3] concentrated mainly on the provision of welfare services. From a hands-off credit attitude in the 1950s and 1960s, based partly on a belief that interest-earning credit was usurious and therefore unethical, the 1970s represented a major u-turn. There was a visible shift from emphasis based on the provision of welfare and relief services towards increasing production and incomes by which the poor would provide for themselves in the future (sustainability), enabling the donor NGO or organization to build in a "withdrawal" time-table. The shift towards production and income generation was also brought about by the realization that welfare services alone did not seem to be creating a fast enough impact on poverty alleviation. Credit became a central plank of this approach, together with skill training, organizational and marketing support. NGOs arguing that the poor are creditworthy, became vehicles for transmitting large volumes of financial services to the poor. According to international donor agencies, NGOs offer less risk, are closer to the poor and more trusted by them (Remenyi 1991; IFAD 1987). Others occasionally slapped a credit component onto an already complex set of activities as if credit was simply a bundle of used clothing meant to be briefly worn and rapidly discarded.

Yet, while the role of NGOs in the provision of financial services is growing by the day, the evaluation of their performances has yet to be systematically undertaken. It is demonstrated in this paper that just as a "confession of ill is not the same as a conversion from ill", NGOs remain unconverted to the idea of liberalizing financial markets. They remain averse to charging positive real interest rates, consciously or otherwise undermine traditional financial systems, and largely lack the discipline required for the provision of sustainable financial services. Donor NGOs are, after all, products of charity and have comparatively easy access to public funds. The urge to provide easy money to others is ingrained (see Seibel, chapter 2).

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1. This paper draws heavily from a forthcoming book which might be entitled, "Professionalising the Provision of Financial Services: The Role of NGOs." This book is based on an extensive review of ACORD's experiences with credit in East and the Horn of Africa. I would like to acknowledge FACET BV for the excerpts. It also draws from a policy document being prepared by ACORD on "Operationality in Turbulence."
2. The Agency for Cooperation in Research and Development (ACORD) is a consortium of European and Canadian NGOs working for long-term development in 14 countries in Africa. The views expressed in this document are entirely those of the author and do not necessarily represent those of the Agency.
3. The term NGO applies to a wide variety of organizations, ranging from community groups and associations to international bodies involved in a wide range of development interests within and across nations. In this chapter, the term applies narrowly to those institutionalized organizations that either implement or finance activities in poor communities, directly or indirectly by channelling funds from elsewhere.

But if that is so, why not continue to provide gifts (grants), one would ask? After all, grants can be provided in complex and creative ways to satisfy the concern for creativity and non-dependency. I will argue that the manner in which operational foreign NGOs deliver financial services reflects either a confusion of objectives or that credit is indeed conceived as a mechanism for recycling grants. Unfortunately, grants signify the pouring of resources into a bottomless pit. Therefore, except in emergency situations, there is a tendency to stigmatize grants.

The shift into the provision of credit, especially in the 1980s, did not necessarily correspond with an increased capability to manage money. NGOs never really had to manage money in the true sense, but were accustomed to channelling money, not managing it, therefore there was little by way of concrete experiences to emulate. The concept of the cost of money is still a strange one for many NGOs, including the big ones. Many times one comes across large credit funds managed by entirely unprofessional and untrained staff, the schemes themselves carelessly conceived, designed and implemented, generating an enormous waste and actually leading to either the indebtedness of the poor or their increased dependency on external support. These outcomes are perhaps acceptable only if a learning process were taking place.

An enormous amount of literature has been generated from NGO experiences with credit in recent times (OXFAM 1987; Havers 1991). The popular messages coming out of this literature may have encouraged more self-congratulation, or even romanticism, than realism about NGO financial management capabilities. A few relatively successful cases, mostly in Asia (Mosley and Dahal 1987; Kropp 1991), have attracted immense attention which has led to programmes for replicating these models (Hulme 1991). In the case of Africa, this preoccupation may well be misplaced, especially given the degree to which infrastructure and communications deteriorated in the 1980s. At the very least, basic infrastructure and communication systems need to be put back again before expanded financial systems can work or before the replication of any banking models can be successful. Poor infrastructure and communication increase the unit cost of financial systems and act as disincentives to investment. Deprivations resulting from such factors cannot easily respond to credit (see Von Pischke, chapter 4).

In addition, basic financial management capabilities need to be built. There are NGO staff running large credit funds who do not know how to prepare a balance sheet, let alone how to monitor loan performance and balancing portfolios. In addition, the institutional and environment conditions under which most NGOs operate generate enormous constraints on the expansion of financial services. These constraints need to be properly understood. The rural African environment under which most NGOs work may, in several cases, be too harsh or inappropriate for grand models.

But first it seems to me that the urgency lies in understanding what not to do in terms of providing financial services to avoid creating more disasters. Drawing upon ACORD's experiences, I will first discuss the environment to which credit is applied and the nature of the assessment of that environment. Secondly, I discuss the manner in which credit is applied. Thirdly, a check-list of lessons is provided.

Incongruence or Confusion of Objectives? The Case of ACORD

ACORD is an operational agency, meaning it is actually present in a community directly or through support to government staff or an intermediary local institution. As an operational agency, it plays a variety of roles, varying from relief in times of crisis, after-crisis rehabilitation, to acting as a conduit of aid funds. Its mandate is to reinforce existing local structures where they exist or to "facilitate the emergence of" local structures where they either do not exist or are weak (see Table 1). The belief is that local structures can better translate short-term assistance into longer-term application and that the stronger they are, the more resilient they will be. Strong and resilient organizations of the poor can act as fora for bargaining with external bodies and for defending the interests of the poor.

Unlike many donor organizations, ACORD is unique in the sense that it is able to work in an area for a reasonably long time exceeding 10 years on average. Because of its nature as a consortium, it is able to mobilize resources from a good mix of agencies to support programmes in areas where funding is hard to come by. Its priority choice for local institution building gives it a leverage in the promotion of locally controlled sustainable programmes, providing a conducive environment for the promotion of reciprocal systems, including informal financial services. These could benefit indirectly from an improved environment, or they could be provided with targeted support to become stronger or to make the transformation, where desired, from for example rotating savings and credit systems into non-rotating systems or other adaptable financial systems. This task presupposes, however, that ACORD itself has proven capabilities and expertise in the field. If not, any meddling could be destructive.

The history and character of NGOs as providers of free or cheap services engender instinctively the tendency to underprice all services, including financial services. Credit is used more or less as a means to achieving two

Table 1: Time Line of ACORD's Activities

Year	*Policy Priorities* *Core Policy*	*Secondary Focus*	*Use of Credit*
1975	Institution-building	Rehabilitation	- Herd reconstitution - Seed banks
1979		Training	- Construction of artisan workshops
1981-1985		Production systems and economic focus	- Agricultural inputs - Micro enterprises in urban centres - Housing loans for refugees
1985	Reinforcing local community based organizations		– Establishment of cereal banks - Support for savings and credit groups - Community managed cereal banks
1988		Women in development	- Savings and credit groups for women - Credit for women's income generating enterprises - Financing asset acquisition by women
1990		Gender	- Encouraging mixed groups of men and women - Encouraging joint enterprises - Financing asset acquisition
1992		Operating under situations of turbulence	- Encouraging complementarity between relief and development projects - Key role of decentralized decision-making under crisis situations - Strengthening local structures as "stabilizing" points in crisis situations

Source: Adapted from "Operationality in Turbulence." An ACORD internal document prepared by the ACORD Research and Policy Programme (RAPP), December 1992.

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inter-related objectives, that is, a tool for rationing limited aid funds and as a means of reducing aid dependency. There is a belief that requiring communities to contribute marginally towards a service financed by aid agencies transforms their mentality from one of dependency (the way aid agencies tend to perceive the poor) to one of self-reliance. Credit provided by aid agencies for these purposes tends to carry highly subsidized, even zero, nominal interest rates. The repayment and monitoring arrangements are often loose and high recovery rates are exceptional rather than the norm. Most of these loan schemes are usually not linked to savings mobilization. Credit in this case is another name for disguising a gift (grants).

ACORD has historically used credit as a means of achieving many objectives, such as: relief from crisis, security against hunger, refugee resettlement, income generation, achieving "self-reliance". ACORD has been involved in rural micro-credit in Benin, Mali, Guinea, Uganda, Rwanda and Angola. It still operates micro-credit for urban-based micro enterprises in Port Sudan and Kassala, both in the Sudan; and rural non-agricultural credit in Rwanda. It has used credit as a mechanism for agricultural input support in the refugee settlement of Qala-en-Nahal in Sudan and for food security through grain and seed banks in Burkina Faso, Mali and Benin. In most of these cases, until recently, neither the sustainability nor the replicability of the financial system were crucial objectives. Only in the Uganda case is savings made a precondition for extending credit. Only in Sud Gisaka, Rwanda, and to some extent the Uganda and Mali programmes, did the credit scheme build upon the experiences of informal financial systems.

Since credit was introduced into ACORD's programmes, a substantial amount of money has so far been disbursed. Cumulatively, the Port Sudan credit funds alone approach £2 million since the scheme was established eight years ago. Only in a few cases, like Port Sudan, Kassala and Uganda, have the credit funds revolved in such a way as to preserve the value of capital in any significant way. In the case of Port Sudan, in spite of reasonably good repayment records (an average of 95 percent over eight years), the scheme has had to be substantially replenished as a result of inflation-related erosion and high operating costs. Similarly, the Uganda schemes have had to be sustained at the cost of a large staff size. These relatively successful cases have credit as a major focus and other activities, such as skill training, marketing advice and group organizational support were added as supporting services. Efforts are made to recover loans and client selection procedures are quite strict.

The Environment Under Which Financial Services Are Provided

An alleged distinguishing characteristic of NGOs is that they choose to work under the most difficult circumstances, where because of the lack of capacity or otherwise, governments and institutional donors do not easily reach. ACORD classifies the situation under which it works into four: communities engulfed in severe crisis, crisis-threatening situations, communities recovering or rebuilding from crisis, and communities dealing with change due to trend phenomena, such as population pressure on resources or the inability of traditional production systems to cope with change. Table 2 contains a recent classification of ACORD's work environments.

Any semblance of long-term productive investment support is inconceivable in areas of severe crisis, and such areas are increasing. Communities recovering from crisis, typically require basic rehabilitation of services, infrastructure and a supportive and flexible environment. In crisis-threatening situations the provision of financial services could at best be part of a strategy to strengthen local control of resources and consolidate cohesion.

Even in areas where the tension between survival demands and existing systems and resources have not reached their absolute breaking point, the conditions remain harsh for the operation of large-scale financial systems. In rural areas, it is amongst dispersed populations in isolated communities, far from major markets and usually dependent on small-scale agriculture, or pastoralist communities that ACORD tends to work. Transport and communication systems are usually difficult, physical infrastructure severely deteriorated. Access roads linking villages and markets are limited. Non-cash exchange transactions may still be substantial. Financial services may usually be provided on the basis of personal arrangements between and among traders, between farmers and middlemen/traders or between small borrowers and professional moneylenders or pawnbrokers. Where formal financial institutions exist, they are dispersed, cater for a narrow and segmented market and largely irrelevant to the majority. But in spite of their isolation, rural communities are not necessarily immune from the effects of bad policy. For example, pastoralists cannot sell their cattle when foreign meat is dumped on the local market, or when over-valued exchange rates prevent them from selling across borders.

Typically, then, the environment is a hostile one and the least amenable to credit, especially large or long-term credit. Dispersed populations increase transaction costs. The problems with infrastructure and the size of the cash economy mean that turnover will be lower than can cover cost of lending. Even lending for survivalist activities carry high risks, let alone for agricultural purposes, yet a higher premium to cover risks is unlikely to be absorbable. One would have thought that under circumstances like these, the best option would include: not to inject substantial credit, but instead to concentrate on stimulating the environment that enables informal savings and credit systems to flourish, to pay more attention to physical infrastructure, communication, health and education, and to inject capital slowly and progressively into the broader economy in general. What we experience instead, is that it is these areas that are targeted by donors for large doses of credit funds. This is often justified by the rather simplistic analysis that identifies lack of capital as the major constraint to unlocking the door of development.

Understanding the nature of crisis and potential crisis in the crisis-prone areas in Africa is important for understanding the appropriate systems that NGOs should promote. The promotion of formal systems or institutionalizing of informal systems is based on the perception of change as smooth, with cyclical oscillations, ordered and linear. If change were perceived otherwise, that is rapid, discontinuous, turbulent, the nature of financial services and the arrangements for providing such services will need to be more carefully thought through and to emphasize flexibility and adaptability as essential criteria.

Under conditions of turbulence, it may make more sense not to interfere with informal financial systems that work and are more adaptable to change than institutionalized structures. Introducing new models developed under different environments into untested grounds and the replication of successful models will require great caution and testing. The replication of the Grameen model and programmes designed to link formal with informal financial systems (Seibel and Parhusip 1990) are among the latest donor obsessions. It is unlikely that the two systems can be integrated harmoniously. Informal financial transactions survive crucial tests because of their flexibility and adaptability but also because of their integration into social relations. Under turbulent situations, the crucial contribution of financial services might be towards strengthening security and insurance. Informal financial systems are more capable of providing this service than formal financial systems because of the former's integration into reciprocal and socializing functions of the societies in which they operate.

Table 2: Support Needs and Roles of ACORD in Different Programmes

Situation	*Programs*	*Support Needs*	*Priority Roles for ACORD*
Community engulfed in severe crisis	Somalia Southern Sudan Mali Northeast Kenya East Africa Mozambique	Relief (food, shelter, medicine, etc.), preservation of local culture, strengthening of local coping mechanisms, political protection and lobbying, securing production	Liaison between community and external providers. Thinking with community, being there, moral support, emphasis on life-enhancing principles
		Women as guardians of family and culture and as providers	Women not to be seen as victims but recognize vulnerability, need to avoid dependency
Crisis threatening	Port Sudan Red Sea Hills Chad Rwanda Angola	Preparedness for possible crises, contingency planning, securing production, diversifying options, strengthening coping mechanisms	Consolidate local control and management of resources by credit, training, support to organizational capacity
		Women as managers and consumers of shrinking resource base	Ensure women directly involved and supported in all projects
Community is recovering or rebuilding	Uganda Namibia Eritrea Ethiopia Burkina Faso Burundi	Political stability, democracy at all levels, organizing capacity, regrowth of self-confidence, increased ability to deal with next crisis, securing and restarting production, rehabilitating or establishing infrastructure	Training in broadest sense, move towards network building, strengthen people's ability to place demands on government, build economic foundations for group development
		Women's role confused, gender relations in process of readjustment and renegotiation	Promote and strengthen women's groups and women in mixed groups
Community dealing with trends	Guinea Benin Ghana	Income generation, enterprise development, savings and credit, sustainable health and educations systems, environmental protection, capacity building, institutional development	Encouraging strategic alliances, increasing ability to dialogue with the state and undertake national and international lobbying, preparing for withdrawal
		Need to reinforce women's entitlements and rights to gain access to credit, health, education, legal protection, etc.	Promote and strengthen women's ability as individuals and as groups, to develop networks and alliances with progressive agencies, legal services, etc.

Source: Adapted from "Operationality in Turbulence." An ACORD internal document prepared by the ACORD Research and Policy Programme (RAPP), December 1992.

Formalization or Is It the Destruction of Informal Financial Systems?

Operational external NGOs descending upon a community often assume that either financial systems do not exist where there are no banks, or that where they recognize the operation of informal systems, they are presumed inadequate. The most celebrated example of distrust of informal financial mechanisms is the picture of the local money-lender generally as a malignant and exploitative character whose activities must be undermined, not complemented. Any recognition of his positive contribution to development and the services he provides to the borrower in the absence of any alternatives is hard to come by.

It is presumed that formal financial systems will either more efficiently and cheaply reach all borrowers or are the conduit to modernization. But as experience has shown, formal financial systems are costly, wasteful, limited, and manipulated by the rich. Where they do not succeed in suppressing informal systems, they may operate side by side, usually exerting a corrupting influence on the latter. Where informal financial systems are acknowledged as performing a useful role, they are nevertheless considered too primitive or slow to create quick development. NGOs usually have three typical reactions, i.e.: ignore them, seek to transform them into forms they can control and influence or seek to formalize them so as to pump more money into them.

Throughout Africa -- both rural and urban -- there are active informal financial services. These may operate on individual basis through networks of traders and suppliers, family credit, unlicensed pawnbrokers, etc. They may also operate in some organized forms. These are called several names, *Tontine* in Rwanda, *Susu* in Ghana or Senegal, *Fongongos* in northern Tanzania, *Equb* in Eritrea, etc. These are essentially Rotating Savings and Credit Associations (ROSCAs) or Accumulating Savings and Credit Associations (ASCRAs). The operational details may vary from place to place, including the average number of people, the regularity of the rotations, the winning formula, etc. They are legitimate contracts into which several people enter for their financial needs and are in congruity with the norms and cultures of the place.

ROSCAs and ASCRAs (Bouman, chapter 22) are superior to formal financial systems in several respects. They are adaptable to the conditions of members. They do not require complicated loan processing and recovery procedures, therefore they tend to be less costly. In the case of ROSCAs, there are no assets at any time, therefore the temptation to be dishonest is minimal. They combine savings with credit and demonstrate types of relationships that are conducive to the participation of the poor. Relationships are built on behavioral norms and practices akin to the society. This also ensures that participants are disciplined and accountable.

One reason why these informal financial systems have managed to outlive unpredictable changes is their adaptability. Formal systems are less useful under the harsh macro-economic conditions that characterize most of the African countries. The ACORD Kassala small enterprise programme in Sudan, for example, disbursed funds amounting to £60,000 in 1991. A drastic devaluation accompanied by an inflationary upsurge reduced the fund to the equivalent of £9,000. Overnight, there was pressure to adjust staff salaries by at least 200 percent. If this was a bank, it would have long gone bankrupt without physical asset revaluation. If these funds were operated by ROSCAs, the rate of circulation would have been faster, repayment periods shorter, and there would have been no, or fewer, cash assets to depreciate.

Institutionalizing ROSCAs could increase operating costs, modify the terms of the contract, introduce new norms, insert mediators between savers and borrowers and bureaucratize behavioral relationships. That said, where transactions become more complex, and the demand for credit increases, non-rotating systems may be appropriate. In most cases, ROSCAs take their own initiative to undertake the transformation. As ASCRAs produce assets, financial recording and new rules will need to be developed. There is a role for NGOs in such a case. This should be no excuse for flooding them with credit. The important lesson is the need of identifying and understanding informal financial systems, perhaps seek to build upon them rather than rush to set up parallel schemes.

The Problems of Donor-Driven Credit

In the course of eight months four key donor missions visited Northern Uganda, Nebbi District in 1991. These were the World Bank, the UN Capital Fund, World Vision International and the Netherlands government. Each one of them was seeking to design credit schemes for small and medium-scale enterprises (SMEs). Very often, one mission did not know the other had been there already.

If these programmes were implemented, together with ACORD's credit programme then already operating, it would have led to a cash outlay of more than 10 billion Uganda shillings[4] over five years. This amount was targeted at an active adult population of less than 100,000, and in an area where it takes two to four days to reach the nearest urban centre, or a full day to carry your wares on your head to the nearest village market and back. It is an economy which relies on rain-fed sorghum for household purposes and cotton and fish as tradeable goods. The majority of the population suffer from severe bilharzia infections, and more recently AIDS related diseases have become prevalent.

It does not take much to realize that this level of credit, applied to such a high-risk rural environment with extremely poor physical infrastructure and financial markets, was nothing but excessive and inevitably problematic if not wasteful. They are the seeds of cheap credit which, like the government institutions, have the effect of damaging informal financial markets through saturation and later indebtedness. This phenomenon, sadly, is not a unique one. These programmes are donor-driven, and donors have the tendency to extricate themselves from failure. It is also an indictment of consultants, for it is they who design the programmes, based usually on patchy information and snappy tourist-type visits.

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4. The exchange rate of the Uganda shilling to the US dollar in October 1992 was Sh1,000.

Already, the ACORD credit scheme was experiencing repayment difficulties. ACORD had pumped US$51 million into the local economy a year earlier. Commercial and retail avenues were exhausted as every borrower sought to stock his shop with the same types of goods. Cotton, the main exportable crop, was hampered by delays in payment by the parastatal Lint Marketing Board (LMB), which was in turn constrained by liquidity problems imposed by structural adjustment agreements. Food agriculture was severely affected by bad weather and cassava mosaic infections. Loan repayments declined to something like 75 percent, with most repayments made after a considerable period past due.

The Distinction Between Consumption and Production Credit

The desire to provide credit only for productive activities is based on the belief that productive investments will create the income base for servicing loans plus interest. Productive investments is indeed the precondition for sustained credit.

This distinction may be desirable for large loans whose repayment is very much linked to the productivity of the activity being financed. In the case of micro loans however, the distinction between consumption and investment credit may be misleading. There is no evidence that repayment is higher for so-called productive loans than non-productive loans (see Heidhues, chapter 3). The repayment performance of the housing loans introduced by the Port Sudan programme is not significantly worse than that of the non-housing loans.

The distinction may also be misleading if the presumption is that there is a strict division between consumption and investment application in poor households or that these distinctions can be monitored. In fact, this is not possible given that money is fungible, meaning that money meant for one type of expenditure can unnoticeably substitute for another. No lender has the time and resources to monitor strictly the use of loans. Moreover, consumption is by itself a legitimate objective of financial services. Consumption expenditure, in some cases, may be hard to distinguish from production expenditure, especially if the consumption credit is meant to sustain the most important factor of production, labor. Also, if a farmer borrows to make up for a temporary food shortfall, she or he may save a goat which would otherwise have been liquidated. In a sense this type of credit can be viewed as an insurance mechanism, since it basically provides security, enabling the farmer to postpone the liquidation of an essential asset.

If food security is the main concern, NGO credit might be more useful serving to stabilize food supplies than investing it in high-risk agriculture. Credit provided to meet the cost of education is both an insurance as well as an investment instrument. Its availability to the poor in flexible forms may well be the most secure insurance.

Typically, these types of credit must be small on average, and can be provided with minimum procedures and therefore inexpensively. They do not need bureaucratic structures to function. They could be managed by community groups or informal groups, whose use of social norms and peer pressure will ensure repayment. They also blend into family savings, augmenting them in the process. The grain banks of West Africa or the livestock credit of Qala-en-Nahal are examples. Yet these schemes are not as popular perhaps because they do not require grand structures and procedures that create employment for the middle class, or used to finance political show-piece projects.

Implementation and Management of Financial Services

Managing Operating Costs

Not many NGO-credit schemes, including the relatively more successful ones like BRAC in Bangladesh, can meet up to 50 percent of their operating costs from their interest rate spread. Indeed, there is a long running debate as to whether it is necessary for them to do so. Nevertheless, a key component of sustainability lies in meeting operating costs. Depending on 90 percent or more on donor funds to meet operating costs is unhealthy for any credit programme.

Many NGOs involved in credit cannot even estimate their operating costs because staff are involved in many more activities than credit. In areas where credit is the major plank of their activities, the problem is how to manage costs. There are two major reasons for this. One is the difficulty of the environment itself, including the type and size of clients. The other is a product of donor-driven credit. It is the cost of engineering a community (clients) to fit into a need externally identified.

A good example of the latter is a set of identical rural credit programmes initiated by ACORD in three districts of Uganda: Gulu, Nebbi and Mbarara. In each, ACORD carved out areas with active adult populations of less than 20,000 people. As an advance over previous practice, emphasis was placed on mobilizing savings. It was thought that given the years of military conflict from which Uganda was just emerging, traditional structures were unlikely to be available or strong enough for building trust and confidence, a basic prerequisite for providing loans. Therefore, small self-selected groups not exceeding 15-30 (depending on the specific area) people each were encouraged to form savings and credit groups. These groups were to pull together their cash savings into a common pool from which they to make short-term loans. Indeed, groups did set up ASCRAs and loaned to members on a monthly basis at rates of interest sometimes exceeding 30 percent. In spite of this high cost, the demand for credit remained high. The interest payments were usually capitalized into the group fund and divided among members only at the end of each year. Rural Development Workers helped these groups to build cohesion, and to record their financial transactions. They were taught simple book-keeping, interest rate policy, simple business profitability analysis.

In two years, the total savings mobilized by more than 200 ASCRAs in one area amounted to about £25,000, an amount larger than the capital funds of the Commercial Bank in the area. ACORD supplemented these funds with a whopping £50,000, followed by another £20,000 the following year. The justification for this supplement was that the relatively high monthly interest rates charged by the ASCRAs, was an indication of excess demand for credit. Secondly, an injection of external capital would hasten the pace at which groups mobilized savings and would enable groups and their members to undertake larger investments. To ensure that the scheme was properly implemented and groups would be capable of managing the larger funds, the well-trained force of Rural Development Workers (RDWs) stepped up their training to groups, and assisted them to organize into credit committees who would help ACORD to define credit policy and disburse and recover loans. The staff-client ratio in this particular programme is something like 1:40. The staff-client ratio was even smaller in the urban enterprise support programmes in Port Sudan and Kassala. But the problem in these programmes was the cost of operating the schemes which, in some cases, far exceeded the value of loans provided. Staff salaries were, in the case of Uganda, far above the official scales.

How such operating costs can be sustained by a local agency is open to question. Whether this level of expenditure for client preparation is desirable, is open to question. Whether, it is unavoidable, we think it is. An evaluation is required to determine the impacts of such training in terms of value added for the clients themselves and ACORD's operations in particular. What seems to be clear is that a rural population size of 20,000 is simply too small to permit a diversified loan portfolio and to avoid the correlation of risks among clients subjected to similar conditions. Such a size leads inevitably to subsidized or excessive credits and invariably to the indebtedness of the clients. This may be a manageable size for organizational support and provision of services, not credit.

Interest Rates

Interest rate policies vary per programme. The micro-enterprise programmes in Port Sudan and Kassala do not charge interest and do not make cash loans because of Islamic legal constraints. Loans are in kind and have a mark-up for services of 14-15 percent. The three Uganda schemes charge close to market rates. Rates vary according to whether credit is extended for production or trade purposes. Agricultural credit usually attracted lower rates. The Qala-en-Nahal programme in Sudan operates a small business credit scheme which also charges zero interest.

ACORD's programmes in Francophone Africa seem to be particularly resistant to charging interest. A programme in the Materi sub-Prefecture in Northern Benin, provided credit interest free over four years. Repayment rates are extremely low. ARAMET, a local NGO in Rwanda, provides long-term credit to artisans interest free. There also, repayment rates are negligible. The main problem seems to lie in:

1. The perception by the staff of the role of NGOs as providers of aid. Any charges for services are equated with making profit;
2. 2It is also not understood that it costs money to get money or even to disburse money. Even where there is such an appreciation, it is not found appropriate to pass any cost to the beneficiaries;
3. Fraudulent client behavior sometimes in consort with staff;
4. The limitations imposed by Islamic banking regulations that outlaw interest and cash loans. Only cost-sharing or hire-purchase arrangements are permitted.

One thing needs to be emphasized. The reluctance to charge market rates on the basis that the poor cannot afford those rates does not seem to have been born out by empirical evidence. In most of ACORD's experiences there has been no evidence that interest rates per se discourage borrowing nor affect repayment. What discourages borrowing is unreliability of markets for produce and weather, government liquidity constraints and difficulties of the general environment. When the poor fail to pay, it is either because of uncontrollable factors or that the loan was inappropriately given in the first place. Poor people generally hate debt. Their dignity is very associated with their financial independence. That is one reason why the poor sometimes liquidate assets to service loans inappropriately extended to them by lenders.

It is important also to clarify the importance of positive interest rates. One reason why agencies like the

World Bank often pressurize governments to increase bank rates to positive real levels is, that positive interest rates are necessary for encouraging people to save. There is no evidence that interest rates perform such a role in communities which are largely non-monetized or under hyper-inflationary situations, or where people are severely constrained by poor communication and infrastructure, and where banks are far from people. In such communities, interest rates are important mainly for contributing to financing operating costs and building up funds. Confidence, trust and predictability are perhaps more important conditions for savings mobilization than interest rates.

Drawing Some General Lessons

As observed at the outset, this review only looks at those features of ACORD's, and other NGO programmes from which we might learn lessons. A number of ACORD's specific lessons may be generalizable:

1. There is a good case for NGOs to return to doing what they probably do best, providing social services and acting as confidence brokers in communities. These include organizational development, training and institution building. Grants can be provided in innovative forms for a wide range of objectives. For large donors searching for avenues to spend monies, infrastructure and communication remain crucial constraints to the development of financial services. Improving services has a multiplier effect on financial systems;
2. Donor agencies, including NGOs, should keep clear of hurriedly introducing new financial systems. In several cases, existing informal systems are more appropriate, more adaptable and provide more insurance especially in crisis and turbulent situations. Donors could do better providing organizational and institutional support for savings mobilization and management as well as supporting the creation of a macro environment suitable for informal financial systems to flourish;
3. Credit without savings can be distorting;
4. It is important to differentiate gift-oriented services from credit, or financial services. Mixing the two conceptually can be corrupting or frustrating to functioning informal systems. It is not clear that the major constraint to alleviating poverty in many rural areas is insufficient financial capital;
5. It is not certain how much addition to productivity the entrepreneurial training for micro entrepreneurs makes to the businesses of clients and potential clients. Reducing them, might reduce operating costs;
6. It is perhaps better not to provide credit at all than to provide excessive credit;
7. If NGOs desire greater involvement in financial services, it might pay to think a little more like bankers. They must at least seek to professionalize, to avoid wasting precious resources or upsetting functioning markets;
8. In the case of Africa, we do not understand the impacts of credit to the borrower sufficiently. Most monitoring and evaluation measure performance of the loan rather than its impacts on the businesses financed by the loans and the impact on the quality of life. Quality of life indicators may be more appropriate for overcoming the fungibility complications of credit than purely economic measures. This is especially so for micro credit;
9. Uncritical replication of other models could damage, through paralleling, informal systems that function. In addition, they should not be another excuse for excessive credits.

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11

Using Contracts to Analyze Informal Finance

Dale W Adams

The principal problem in understanding the actions of men is to understand how they think -- how their minds work (P.W. Bridgman 1955).

For centuries discussions about informal finance have been filled with confusion and controversy (Nelson 1949)[1]. Moralists condemn it, politicians attempt to control and regulate it, sociologists debate its usefulness, economists dissect it looking for imperfections -- while billions of people voluntarily participate in it. Fashioning a composite picture of informal finance is similar to summing the disjointed reports of judgmental blind people who have independently felt an elephant's appendage; the parts depicted do not add to a coherent whole.

This confusion justifies looking for new ways of analyzing informal finance, ways that do not prejudge the virtue of the activities and people involved, that employ common units of analysis, and that also apply research techniques representing the manner in which people make decisions. I propose using contracts as a framework for such analysis. Because of my professional interests I stress their economic aspects.

Background on Contracts

The use of contracts in economic analysis germinated in institutional economics and later blossomed in the study of labor arrangements (Rosen 1985). Interest in contracts has reemerged recently in new institutional economics where transaction costs are emphasized (Williamson 1985), in principal agent analysis (Ross 1973), and in the study of asymmetric information (Akerloff 1970). Literature on this topic has expanded to include implicit contracts (Rosen 1985), incomplete contracts (Hart and Holmstrom 1987), and incentive contracts (Cheung 1969). The analysis has also been extended to include studies of land tenure and credit (Braverman and Stiglitz 1982).

Contracts can be used to describe multifaceted agreements between individuals or firms. They may involve explicit as well as implicit stipulations, they may be written or oral, and they may include few or many elements (Mahoney 1977). Formal financial contracts are often written and contain mostly explicit stipulations, while their informal counterparts tend more often to be oral and involve implicit elements. Some contracts can be enforced in courts of law, while others are enforceable only through social sanctions. In the discussion that follows I argue for thinking of contracts as being the products that are made and handled by financial intermediation, particularly in informal finance.

In neo-classical economics, transactions between individuals are assumed to occur under simple terms; in a cash transaction the vendor contracts to sell a certain amount of a good at a price to the buyer, and the exchange takes place quickly. Economists usually ignore that a contract is involved in these exchanges, because the terms are implied rather than written, the transaction is impersonal and takes place instantaneous and the contract is enforced by general norms of the society. Sellers break these contracts if they fail to give the buyer the good or service upon receiving payment, and buyers likewise break contracts if they appropriate goods or services without paying for them. Failing to fulfill these simple and short-term contracts is stealing in every society.

Contracts are a more robust notion where transactions involve inter-temporal stipulations -- receive now and pay later -- and where risk, inflation, uncertainty, and insurance are considerations. Contracts that govern such transactions typically involve more stipulations than do instantaneous cash arrangements. Time and risk are major components of financial contracts.

1. Formal finance is here defined as those financial contracts that are sanctioned and supervised by government organizations, such as central banks, ministries of finance, or superintendents of banks. Semi-formal finance is provided by entities that operate under government charter but transact financial contracts with little or no government supervision. Informal finance encompasses all other financial lending and deposit taking that occurs outside government sanction or supervision, aside from general rules that apply to fulfilling contracts.

Stipulations in Financial Contracts

Students of informal finance are often amazed at the rich variety of arrangements encountered in most countries. Sociologists and anthropologists have feasted on describing the diversity of these arrangements (e.g. Bouman 1989). Applying the analogy of clothing to contracts, informal finance is able to tailor contracts to fit the individual dimensions, requirements, and tastes of a wide spectrum of lenders and borrowers. Stipulations in each contract can be adjusted to fit the idiosyncratic needs and desires of the parties involved. In contrast, formal finance processes contracts that are more standardized and less individually tailored. Formal intermediaries require borrowers and depositors to “wear” contracts that are largely pre-made.

Participants are able to form nearly limitless combinations of terms and conditions -- both explicit and implied -- in financial contracts. At least eight types of stipulations can be identified with many permutations in each type. These include the amount of the loan, the term of the loan, how and when the loan is to be repaid, the interest payment involved, loan guarantees or collateral requirements, how loan transaction costs are shared, other explicit linked arrangements, and additional implied arrangements that are linked to the loan.

Loan Size

The amount lent is typically the most prominent stipulation in loan contracts. If the loan and its repayment are in cash, the size of loan is denominated in money. If at least one side of the loan transaction is denominated in units of goods or services, the loan valuation problem is less straight forward. For obvious reasons, both borrower and lender generally avoid spending much time negotiating the terms and conditions of small loans but typically expend more time on large loans. Likewise, contracts that deal with small loans usually involve fewer stipulations than those processing large amounts.

Term of Loan

The period or term over which the agreement is in effect is another important contract element. It is common for lenders and borrowers to spend more time negotiating a long-term loan and including a larger number of stipulations than they would in crafting a short-term contract. Both the lender and borrower see a loan for only a month as being quite different from an equal-sized loan for 12 months, for example.

Especially in informal finance, not all loan contracts specify when the loan is to be fully repaid -- some contracts are incomplete or open-ended. An individual may borrow money from a relative, for example, with the implicit understanding that the loan will be repaid when the borrower is able to do so. These open-ended arrangements may be renegotiated and amended later when a specific time for repaying the loan is appended to the contract. In still other cases there may be an implicit understanding between borrower and lender that the time period of the loan is fluid and subject to renegotiation under changing conditions.

Loan Repayment

Aside from loans among friends and relatives, most financial contracts include specifications about what form and when loan repayments are to be made. The loan may be transacted in cash or kind with repayment specifications calling for money, products, or even services[2]. If both sides of the transaction are done in kind there is no finance involved, although a barter loan is made[3]. In some societies debt obligations are inheritable so that unpaid debts incurred by the father are passed on to his children.

Lenders and borrowers also have ample latitude in the specification of loan repayments. Some contracts require that the entire amount of the loan plus interest is due in one lump-sum payment at the end of the contract period. For both the lender and the borrower this pattern of repayment is quite different from one that specifies 1/52nd of the loan be repaid each week for a year. In the first case the borrower has effective use of the entire amount of the loan for a full 12 months, while in the second case the borrower has effective use of only half the total value of the loan for the full 12 months.

A number of additional repayment patterns are found both in formal and informal financial contracts.

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2. Loans that are made and repaid in cash, loans that are made and repaid partly in cash and partly in kind, and various barter arrangements are often partial substitutes. Two farmers may decide to lend and borrow labor from each other through a labor-sharing relationship, for example, instead of borrowing money to pay for purchased labor. In the same sense, crop-sharing arrangements are also substitutes for cash loans.
3. The main distinction between a loan that involves only barter and a loan that involves cash is the additional risk and uncertainty that changes in the purchasing power of money pose for financial transactions.

Adjustments in these patterns have a major impact on the perceived worth of the contract. Loans, for example, that require rice farmers to make daily payments for fertilizer bought on credit would usually result in a mismatch with their cash flows and, thus, would be viewed as an undesirable contract by borrowers. Similar repayment terms on loans made to individuals who sell commodities daily in central markets, however, might be viewed as satisfactory arrangements by both lender and borrower.

Interest Rates

Understandably, the lender's compensation for making loans and the payments borrowers must make for the privilege of borrowing are also important specifications in loan contracts. Both lender and borrower interpret a loan that carries an interest rate of 10 percent per year as being something quite different from one that carries rates of 10 percent per month. There is a large variety of interest rate options. These include simple interest, compounded interest, interest payments that are discounted in advance, add-on interest, and level payments pegged to the initial amount of the loan. The clarification of interest specifications is further complicated by various types of interest rates, such as nominal rates that ignore inflation, real rates of interest that reflect adjustments for price changes, hidden interest charges, and effective rates that take into consideration interest paid, compared to principal outstanding.

The payments made for loans, especially in Islamic countries, may avoid using explicit interest by calling the payments dividends, mark ups, or shared profits from jointly financed operations.

Loan Guarantees and Sanctions

Other important specifications in financial contracts are the guarantee or collateral involved and the types of sanctions that might be applied in case of default. A loan that involves a hand shake as a guarantee is something quite different from one that requires pledging collateral worth several times the value of the loan. In some cases the borrower may lose the use rights of the collateral pledged through pawning. This may include borrowing from a pawnshop in Sri Lanka, pawning use of cocoa trees in Ghana, or pawning paddy land in Thailand. In other cases, contracts involve mortgages that place a lean against pledged property but allow the borrower to continue to use pledged assets. In still other cases, third parties, including groups, may be asked to guarantee all or part of a loan, or third parties may be relied upon to informally arbitrate contract disputes.

Implied guarantees and informal sanctions are prominent in informal finance. Borrowers may strive to repay loans from sources they view as providing high quality and dependable services. In contrast, they may assign less priority to repaying loans made by government-owned banks that provide undependable and low quality services. The denial of access to future loans is a more powerful informal sanction for the first type of lender than for the second.

Each time borrowers take loans, they pledge their creditworthiness in the loan contract. Borrowers who default forfeit their creditworthiness, at least in the judgement of lenders who suffer the default. In the small and highly personalized societies that typify the life of poor people in most low-income countries, a failure to repay one lender can result in an individual losing most borrowing privileges. The ability of the lender to exercise a range of informal sanctions -- including extra-legal force -- is an important aspect of informality.

The provision of loan guarantees may impose costs on both borrowers and lenders. This includes the expenses involved in obtaining documents needed to mortgage property or gifts and payments made to individuals who co-sign loan contracts. In self-help groups members may be required to attend periodic meetings that impose opportunity costs on them as a way of forming mutual trust that substitutes for more tangible loan collateral.

Cumbersome legal procedures in some countries make it costly -- sometimes virtually impossible -- for lenders to legally retrieve assets pledged as collateral on defaulted loans. Under these circumstances lenders compensate by using physical force to access collateral, or by adjusting other stipulations in loan contracts to offset judicial shortcomings[4]. There may also be an agreement that disputes will be submitted to informal authorities for arbitration.

Distribution of Loan Transaction Costs

Transaction costs are important features in many loans and they affect behavior of both lender and borrower. These costs may be either implicit or explicit. One lending procedure may impose relatively high loan transac-

4. In a few countries governments have gone to the extreme of passing debt-relief legislation that nullifies informal loan contracts.

tion costs on borrowers, while another procedure might result in lenders absorbing most of these costs. In general, informal finance is transacted in clients' homes, their place of work, their neighborhoods, or where they shop. In contrast formal financial transactions usually occur on the premises of the financial intermediary -- the client is forced to come to the bank.

The distribution of these costs among the participants is an important stipulation in financial contracts. Peddlers who sell items on credit door-to-door in rural areas of the Philippines, for example, may stipulate they will deliver merchandise and then return daily or weekly to collect loan payments, thus absorbing most transaction costs. In contrast, individuals in Guatemala who live far from town may be forced to visit a bank six or seven times to negotiate loans, to receive disbursements, and then to repay their loans. Such procedures result in borrowers incurring substantial transportation costs and lost-work time, while lenders have relatively few costs in effecting the loan. Likewise, farmers in Uganda may wish to make deposits in distant banks but can only do so by incurring substantial transaction costs, in the form of lost work time and transportation costs, that are much larger than those experienced by deposit takers.

Economists usually assume that interest payments are borrowers' costs of acquiring loans and that interest receipts are the benefit realized by lenders. This only holds, however, if there is no friction in the exchange in the form of transaction costs and if nothing else of worth accompanies the loan transaction. It is unlikely, for example, that rural peddlers who sell on credit in the Philippines or their clients make economic decisions solely on the basis of interest payments, particularly the borrowers. They are more likely to make their decisions on the basis of total lending and borrowing costs, only part of which is comprised of interest payments.

Tied Transactions

Many informal financial transactions are explicitly linked to the sale or purchase of inputs, products, or consumption goods. A farmer in Zaire may extend loans to workers as part of a labor-credit contract; a trader in Nepal may make advanced payments to rice farmers as part of a product-purchase agreement; farmers in Jamaica may give their products to peddlers on consignment for sale and agree to wait for later payment; a merchant in Egypt may sell chemical fertilizer to farmers on credit as a way of boosting sales; and a store owner in Northeast Brazil may allow customers to buy consumer items on credit. Offering credit is a device used by many merchants and traders to promote their main business activity -- a way of competing. Explicit tying of these activities is an important specification in associated loan contracts.

These explicit-tied arrangements include a number of variants. Some loans may involve no interest payment, but require borrower-sellers to accept concessionary prices for their products or services, or for borrower-buyers to pay above-market prices for products or services. In other cases, where one side of the financial transaction involves physical goods, specifications in contracts may require one of the parties to absorb the risk of product price change. In still other cases, the contract may involve other side-agreements that benefit or cost either borrowers or lenders. For example, the *dadon* system in Bangladesh involves traders making forward payments for rice crops before they are harvested, and in doing so agreeing to absorb harvesting costs and price change risks (Ghate 1992).

Implicit Stipulations

Many informal loans are embedded in multifaceted relationships that implicitly tie other activities to lending. These implicit stipulations are as varied as are relationships among people. The lender and borrower, for example, may feel obligated to attend social club meetings in Vietnam or South Africa to reinforce their relationships. Members of informal savings clubs among Korean or Mexican immigrants in Southern California may participate in these groups because they build mutual trust and possibilities of borrowing or doing business both within and outside the group (Light, Kwuon and Zhong 1990; Velez-Ibanez 1983). Individuals in all countries may lend to friends or relatives with the unstated understanding that loans will be reciprocated should the need arise in the future (Platteau and Abraham 1987).

In still other cases, such as in Colombia and Peru, lenders may have patronal relationships with their borrowers. This may include implicit understandings that the patron will intercede for the borrower in legal matters and in disputes with authorities. These implicit agreements may extend to the provision of loans in times of personal emergencies, to holding some of the borrower's funds for safe keeping, and to provision of food in times of disaster. In many cases, informal borrowing-lending is only one of a number of interlaced activities that strengthen interpersonal relationships, facilitate exchange, and allow individuals to survive in uncertain environments.

Trade-Offs Among Specifications

Lenders who craft loan contracts not only have a variety of specifications they can choose from, but they also have latitude for substituting one element in a contract for another. For example, one contract may have a low interest rate but involve procedures that transfer most loan transaction costs to borrowers; at the same time, another contract may include high interest rates but impose few additional costs on borrowers. The same lender may also offer other contracts that contain moderate interest rates, more loan collateral, and a sharing of loan transaction costs between lender and borrower.

Prudent lenders adjust loan specifications to the perceived creditworthiness of borrowers and to prevailing risks and uncertainties. An individual with a bad reputation will be unable to negotiate the same loan contract that a distinguished person might expect. Likewise, a new client will generally be offered a loan with specifications that are substantially different from a client who has previously dealt with the lender. Analogous contract distinctions will be made between borrowers who operate farms subject to droughts, compared to borrowers who have access to dependable irrigation. Similarly, those who wish to borrow large amounts for extended periods of time, likely negotiate loan contracts that are quite different from individuals who request small loans for only several days. This differentiation of contracts is found in informal rotating savings and credit associations in countries such as The Gambia, Mozambique, and Cameroon where new group members may be required to wait until late in the rotation cycle to receive their share of the funds.

From the borrower's perspective, they may be willing to substitute relatively high interest rates for associated transaction costs that are modest and for linked implied agreements that the lender will provide additional loans in times of emergency. Or, borrowers may be only willing to incur substantial transaction costs to secure a loan if the interest charge is modest and other tied services are viewed as desirable.

Products and Prices

In the foregoing I argued that borrowers and lenders base financial decisions on multifaceted contracts and that loan size and interest rates are only two of a number of specifications that are included in these financial products. For some people, the interest payment may be a relatively minor consideration compared to other elements in the contract, especially when loans are small and for short periods of time. Unfortunately, when economists apply their tools to interpreting differences in interest rates across financial markets, both formal and informal, they usually ignore these other specifications. Some economists employ a "morality model" to "prove" exploitation exists in informal finance and cite differences in interest rates on loans made by formal and informal sources as proof of monopoly powers (e.g. Bhaduri 1983). Other economists employ an "economic efficiency model" and cite differences in interest rates on loans as signs of fragmented financial markets that are inefficient in allocating funds among economic alternatives (e.g. McKinnon 1973).

I have reservations about using either the morality or the efficiency model to analyze informal finance. My first reservation is that interest rates often do not represent all of the perceived costs or benefits of either extending or obtaining loans. Second, in my opinion, it is an error to think of informal financial systems as producing homogeneous contracts. Instead, one might better think of heterogeneous contracts as being the norm of what is produced in informal finance.

What Is the Product?

In making judgements about the morality or efficiency of financial market activities it is vital to compare like with like. No one would argue a market was defective or abusive that assigned a lower price on a badly bruised, small apple than on a large, crisp and attractive apple. Everyone would agree that these are two different products in the eyes of consumers, despite the fact that both fruits belong to the apple species.

Part of the problem with both the morality and efficiency models lies in the definition of the product or service -- the "apples-oranges" issue. One should not expect the price that a consumer is willing to pay for two goods to be the same unless, in the opinion of the buyer, the two goods provide equal utility: both apples are identical in quality and size, or both oranges are similarly identical. The fact that a consumer is willing to pay a higher price for one fruit compared to the other based on perceived quality differences, says nothing about the structure of the apple and orange markets, that is, whether or not they involve monopoly power.

A difference in price between two goods is not *prima facie* evidence proving the price of the more expensive good includes monopoly rents. These differences in prices may only reflect the additional satisfaction consumers expect to realize from one fruit compared to the other. Without additional information on the structure of the markets for apples and for oranges, an economist can only deduce something about the ordinal preferences of consumers from such price information. We can only deduce that something is askew in the market for apples if, at the same time and place, two identical apples are sold for different prices: for example, a poor person paying a higher price than a rich person for identical apples. Perhaps we should apply the same logic to analyzing loans and in doing so, we must be careful to compare prices among contracts that are similar.

Price of a Loan?

Most economists think of price as an indication of the sacrifice people incur when they purchase a good. This notion of price is often equated with interest payments when economists make judgements about financial transactions. If contracts are the products handled by financial intermediation, it is not at all clear that the interest payments specified in the contract captures a major part of the sacrifice or benefit borrowers and lenders realize from the transaction in informal finance. Associated transaction costs increase the sacrifice incurred by borrowers and reduce the net benefits realized by lenders. Likewise, other specifications in the agreement may increase or decrease the perceived benefits or costs associated with the contract. Generally, the smaller and shorter the term of the loan, the less important is interest payment in influencing the behavior of participants in loan contracts.

As a minimum, interpreters of informal finance should focus on borrowing costs -- interest payments plus loan transaction costs -- as determinants of loan demand. Since these transaction costs may not vary much with loan size, the borrowing costs are particularly important when evaluating loans that are small and for short term -- the types of loans that are the bread-and-butter of informal finance.

In most informal financial transactions, interest payments are only part of the cost or benefit that borrowers and lenders experience. Economists error when they think of interest payments as being prices of loans and the only determinants of loan demand. We further error when we ignore the tremendous diversity in lending and associated arrangements and think of only the amount of money as being the “product” demanded.

Contrasting Contracts

A brief description of two quite different loan contracts in Bolivia may clarify my arguments. Variants of the first contract are commonly offered to urban street peddlers in the capital city of La Paz. The second contract is one that a defunct agricultural bank often offered to operators of small- and medium-sized farms.

Peddler Loans

Street peddlers occasionally run short on liquidity to buy inventory such as cigarettes, candy bars, gum, and other impulse-purchase items. Numerous wholesalers in central markets provide these items on credit in the morning with repayment due the next day. The average loan is only for the equivalent of US$10, the average term is for 24 hours or less, and a single repayment of US$11 is specified. The simple interest charge is thus 10 percent -- an annualized rate of 3,650 percent. The loans are made with no physical collateral, but borrowers understand that the “word will get around” and that they will likely lose access to most informal loans if they should default. Because these lenders operate in central markets, close to where street peddlers operate, the lender absorbs virtually all loan transaction and collection costs.

While lenders understandably tie loans to the purchase of their goods, they also share valuable business information with borrowers about what goods are selling well or poorly, and also give their most valued clients first access to new goods. Loan agreements are flexible, and most clients are able to negotiate delays in loan repayment and may also ask wholesalers for other emergency loans. In some cases, the lender may intercede as character witness when clients have legal difficulties. Overall, borrowers value their dependable and flexible relationships with these wholesalers, loan recovery rates are high, and there are few borrower complaints about lenders.

Agricultural Bank Loans

Until its demise, the government-owned Agricultural Bank provided small loans with the following characteristics: loan size was about US$300, a single payment at the end of six months was required, and interest was one percent per month. Borrowers were often required to provide loan collateral in the form of a mortgage against property worth several times the value of the loan, and most loan contracts also required co-signers. Procedures forced borrowers to visit the bank’s urban office an average of five or six times to satisfy collateral requirements, fill out papers needed to request the loan, gain final approval of the loan, receive several loan disbursements, and finally to repay the loan.

Unlike some informal lenders, the agricultural bank did not tie its loans to purchase of other goods or services, did not provide useful business information or advice to borrowers, and also did not make emergency loans. One did not have to interview many borrowers from the bank to hear grumbling about the quality of service, requests for bribes, the amount of paperwork, and late loan approval and disbursements. The ultimate demise of the Bank also proved it was not a durable or dependable source of financial services.

There are few similarities among the stipulations written into peddler loans and the stipulations included in loan contracts issued by the Agricultural Bank. In terms of products, about the only thing they have in common is that they are both called loans. A huge variety of other loan contracts can be found in Bolivia with specifications that lie between these two extreme examples.

Conclusions

Discussions about informal finance have been long on value judgements and horror stories and short on careful analysis. They have also overlooked the numerous interesting innovations that erupt in these activities. Applying the notion of contracts to informal financial activities may allow social scientists to clear away some of the fog that currently surrounds this topic and also provide policy makers with some useful insights. It may also allow economists, sociologists, and anthropologists to integrate more of their work. Even more importantly, contracts may allow us to organize information in a manner that more closely resembles the way people actually make decisions about financial activities, both formal and informal.

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12

Barriers to Credit Access in Rural Sri Lanka

Rauno Zander[1]

A key problem in any comparative analysis of formal and informal finance is how to determine borrowers' preference for specific savings and credit systems. Many policymakers -- both supporters and opponents of cheap credit policies -- assume that borrowers base their decisions on one particular loan component, that is, the interest rate. However, other costs of loan transactions might have a much more decisive impact on decisions of (potential) borrowers. The transaction cost analysis, attempting to identify all costs incurred by borrowers and lenders, has shown that interest rates are but one of a set of borrowers' transaction costs. These costs usually include travelling costs to the credit institution, opportunity costs of labor for the time lost in lengthy application procedures, and expenses of updating or organizing legal documents used as collateral.

For more than two decades, analysis of borrowers' transaction costs has served as the analytical tool to investigate decisions of borrowers pro or contra informal and formal lenders. However, I feel that transaction costs cannot explain borrowers' decisions comprehensively. These costs imply a ranking order by borrowers: the cheaper the credit source, the more likely they will try to get a loan from that source. Empirical evidence from my surveys in Sri Lanka suggests there is more at stake. This chapter introduces an alternative analytical framework based on these field surveys. The objective is to identify the existence and scale of entry barriers into formal and informal segments of financial markets.

Earlier Findings from Sri Lanka

The analysis of interest rates has figured prominently in economic studies that compare formal and informal credit sources. Sri Lanka's Central Bank compares interest rates in its various surveys of rural credit markets. The 1976 survey among paddy farmers showed that a large number of loans in the informal sector carried a high interest rate, but also that this apparently did not deter customers (Central Bank of Ceylon 1971 and 1981). Fernando (1988) comprehensively describes interest rates of informal lenders in Sri Lanka and the perception of these rates among borrowers.

However, focussing on interest rates alone is not sufficient to explain borrowers' choices for or against a particular financial intermediary. To a borrower, the interest rate represents but one of a set of total loan costs, that also comprises opportunity costs of foregone labor, the costs of travelling to the lender, and administrative costs such as paying for loan application forms. In a comparative study of formal and informal loans in the Kurunegala District, Gunawardena (1981) not only found that loan transaction costs for borrowers from banks were considerably higher than for customers of moneylenders and traders, but also that formal lenders fail to provide sufficient services:

> The various stages that the farmers have to pass through before they finally get their loans from the banks are beset with a number of obstacles. Running after guarantors and struggling to cut through official red tape are to mention two of the many handicaps that the farmers have to guard against (Gunawardena 1981: 18).

An internal report of the IFAD-supported Integrated Rural Development Project in Badulla suggests that loan transaction costs of informal sources are 14 percent lower than those of banks, opportunity costs of labor providing a decisive cost component.

Lack of data on types and shares of informal intermediaries involved in the loan total, impede a comparison of the two studies. Gunawardena only includes loans from traders and moneylenders, while the Badulla report presumably includes the large share of loans from friends and relatives, typical of Sri Lanka (Fernando 1988), which are free of interest and hidden costs.

Barriers that Borrowers Face

Ranking lenders according to interest rates and transaction costs only, implies that borrowers most likely will make use of those lenders with lowest rates and costs. But borrowers' decisions to accept or reject are influ-

1. I wish to thank Professor von Blanckenburg for his support and encouragement and the German Research Council (DFG) for funding the project.

enced by other factors as well. The following barriers may prevent potential borrowers from applying for a loan:
1. Prohibitions on lending to former defaulters;
2. Collateral may not be available, especially when land titles are required;
3. Guarantors may be difficult to find, especially for people without connections in the higher strata of village society. Even when this is the case, there is a problem if a regular tax payer is required as a guarantor. Borrowers in urban areas have found a way out of this. A secondary market for guarantors has emerged with brokers bringing borrowers and a guarantor together. This can easily be included as a transaction cost for the borrower, but in the villages an applicant without the right friends may have to abandon a credit application altogether if no wealthy guarantor supports his request for a loan;
4. Some people have psychological barriers against using banks, or cannot cope with the complex procedure of a credit application typical of many institutional lenders;
5. Social proximity and personal knowledge between creditor and debtor. On the one hand, lack of close personal ties can constitute a barrier to entry. On the other hand, a borrower might not choose the most cost effective loan source, but the lender with whom he feels most comfortable in requesting a loan;
6. One may be excluded from borrowing because of political reasons.

Many borrowers are not able to overcome these barriers irrespective of the transaction cost level. An analysis explaining decisions for or against certain loan sources should take these barriers into account.

Even if there are no barriers to entry into the rural credit market, borrowers' decisions may still be influenced by factors other than those usually typified as transaction costs for borrowers, such as:
1. Flexibility of repayment: moneylenders are an attractive source of loans because they often do not demand any specific date for repayment of the principal as long as the interest payments are serviced;
2. Mismatch of credit offered and actual loan needed;
3. Sanctions in case of non-repayment can deter credit applicants even from credit sources with low transaction costs;

The Bias of Conventional Methods

It is interesting to observe that the bias towards a ranking order in the transaction cost analysis is self-determining because transaction costs are only calculated for customers who already have entered a credit transaction. Potential applicants, not able to overcome the barriers of entry, are not included in the analysis. But how can a method highlight decision patterns, when the approach only encompasses actual borrowers, and neglects rejected applicants or those with the rational expectation to be rejected should they try to utilize a certain source?

In summary, the transaction cost approach not only fails to address important factors influencing entry into the credit market, but also reinforces this bias by the methods it employs. Low transaction costs are therefore not admission tickets to financial services (Von Pischke 1991: 11). Only if access barriers of different sorts are overcome will transaction costs play a role as a useful tool for explaining decisions of borrowers for or against certain financial intermediaries.

Comparative Analysis of Loan Components

The analysis of borrowers' decisions has nevertheless benefitted from the introduction of transaction cost calculations. Instead of focussing on the interest rates of a loan only, other components are included as well.

The following method to analyze borrowers' decisions attempts to cover all relevant components of a loan contract. As a first step, these loan components are identified. Their relative importance to rural borrowers is then assessed in two field studies. These loan contract components are:
1. Average distance of lenders to borrowers;
2. Sanctions in case of late or non-repayment;
3. Conditions of lender for use of loans;
4. Interest rate levels;
5. Timely provision of loans;
6. Loan amounts;
7. Repayment periods;
8. Securities required;
9. Guarantor arrangements demanded by intermediaries.

This list may not be complete, but probably covers the most important decision parameters of borrowers for or against specific financial intermediaries. Obviously, the relative importance of loan contract components may differ per location and at different points in time. Nevertheless, the list constitutes a useful starting point for a comparative analysis of formal and informal financial services from the (potential) borrowers' point of view.

The Two Field Surveys

My own study was based on two field surveys: one in a rural area close to a modern urban environment, and another in a purely agricultural, remote area of Sri Lanka. Both sites were selected with a view to the presence of a dense network of rural banks, typical of most parts of rural Sri Lanka.

The village of Mabodale in the Gampaha district, about 50 kilometers north of the Sri Lankan capital Colombo, was selected as characteristic of a semi-urban location in the immediate vicinity of the Katunayake Free Trading Zone. Mabodale consists of 716 households. Six months were spent in this village to implement the field survey (February to July 1990). The second village, Makkaduwawe, was chosen in a purely agricultural setting in a remote location, the Northern Kurunegala district. The village consists of 204 households. Data were collected there during a three-months period from August to October 1990.

Mabodale

The village Mabodale is located in the low country wet zone. Mean annual temperatures of this zone vary between 27 and 29 degrees celsius, with a relative daytime humidity of about 70 percent. The annual rainfall of about 2500 mm peaks during April-May and October-November, and determines the two cropping seasons, Maha and Yala.

Villagers work in Colombo or in the adjacent Katunayake Free Trading Zone. Consequently, part-time farming is widespread. Cropping patterns are dominated by coconut, unirrigated paddy and fruits and vegetables that thrive in the humid tropical climate. Animal husbandry plays a minor role only.

Small industries in the village comprise two handloom weaving shops. Micro-enterprises are operated alongside a nearby through road or within the houses. Seasonal agricultural work is common.

A period of violent political conflict caused by a Singhalese guerilla movement, the Janatha Veramukti Peramuna (JVP), came to an end in 1989. Villagers were seriously affected by the prolonged period of political instability and civil unrest: loss of life was minor, but income losses were considerable (Zander 1991).

Makkaduwawe

Makkaduwawe village borders the Sri Lankan dry zone. It is situated in a remote and isolated part of the Northern Kurunegala District, with only one small town nearby.

Agriculture predominates in Makkaduwawe, where almost all heads of households are full-time farmers. Farming in the village with mean annual temperatures of 30 degrees celsius, and less than 1000 mm precipitation, relies heavily on irrigation. Rainwater is collected in catchment basins. Water shortage allows regular cultivation only in the Maha cropping season. Paddy is the predominant crop, largely for subsistence needs. The climate does not allow the cultivation of coconuts. Necessary products like coconut leaves, nuts or trunks have to be imported from the southern part of the district.

Micro-enterprises are restricted to shopkeepers, carpenters and a laundry business run by a family of the low *dhobi* (washermen) caste.

The village is very impoverished; 70 percent of the adults are food stamp recipients and incomes from farming are much lower than in the semi-urban village.

Farmers suffered extensively from the period of political unrest. The JVP ordered bans on farming which decreased the already small incomes to critical levels. Borrowing in this village is mainly to ensure a minimum food supply.

Survey Methodology

Two surveys were carried out, using different questionnaires. The first one was to get familiar with the economic landscape and to identify financial intermediaries and their clients. It comprised 263 adults from 97 households (13 percent) in Mobodale and 103 adults from 40 households (20 percent) in Makkaduwawe. The second survey posed specific questions on borrower-lender relationships. It included 158 persons from Mabodale and 76 from Makkaduwawe, both men and women. In addition, the extent of ROSCA-membership as a financial self-help mechanism was explored. Results are given in Table 1.

Interviews with lenders were flexible, using partly open, partly pre-structured questionnaires. Managers and officials of banks, credit cooperatives, NGOs, moneylenders, shop owners and produce buyers were

Table 1: Credit Relationships in the Survey Villages

Source of Loans	*% of Total in Semi-Urban Mabodale*	*% of Total in Remote Rural Makkaduwawe*
Friends and relatives	36	37
Moneylenders	19	14
Traders and shopkeepers	15	19
Banks	13	15
NGOs	8	-
Credit cooperatives	11	22
Other sources	4	2
Total[a]	106	109
ROSCA membership	56	20

[a]Totals exceed 100 percent, some respondents having two or more loans.

Table 2: Scope of Interviews with Formal and Informal Lenders

Type of Lender	*Semi-Urban Mabodale*	*Remote Rural Makkaduwawe*
Produce buyers and traders	11	-
Shopkeepers[a]	20	7
Moneylenders	12	14
ROSCA organizers	4	2
Rural bank managers	7	4
Credit agents of banks	2	-
NGOs	3	-
Credit cooperatives	2	1

[a]Shopkeepers also buy agricultural produce.

approached to get details of the kind of financial services that they supply in the village. Table 2 gives the numbers of interviews with these lenders.

Survey Results

Three out of the nine components proved of minor importance to borrowers' choice of credit sources. They are outlined in the first three of the following sections. The six other components with a major bearing on the decision for or against a financial intermediary are then investigated in the final six sections. The chapter concludes with a summary of the most important findings.

Average Distance to Borrowers. All credit sources in both villages are within easy reach of borrowers. Only some moneylenders in the semi-urban village are 20 kilometers or more away from the households, because they are close to the place of employment, the Katunayake Free Trading Zone. Banks were nearby because their presence was a selection criteria for the two survey areas.

Sanctions in Case of Late or Non-Repayment. The threat of penalties or personal harassment in case of late or non-repayment of loans also plays no major role in the choice of credit sources. Banks do not exchange information on defaulters and are generally reluctant to pursue their claims in courts. Even if they take legal action, the chances of recovering bad debts are limited. Sri Lankan statute books, a remnant of the Dutch and British colonial past, provide that weaker sections of the society are especially protected. This is one reason why banks find it difficult to enforce repayment of overdue and doubtful loans in courts.

Informal lenders have an advantage. If they are not afraid to open their books to the village administration officer (Grama Sevaka), he may settle default cases peacefully. Serious personal harassment from informal creditors demanding repayment of overdue loans hardly occurs. The threat of a possible denial of a future loan seems a sufficient incentive for high repayment rates in the informal sector.

Conditions of Lenders for the Use of Loans. Banks and NGOs[2] generally require loan applicants to state the intended loan purpose. Exceptions are advances against the deposit of a pawn or the small instant loans from NGOs. Field officers of banks inspect the use of loan capital when large loans are involved.

Certain lines of bank credit are linked with specific purposes. The most notable specialized credit line in the

2. The term NGO is used in a wider sense and also includes the Sanasa Thrift and Credit Cooperative Societies.

Table 3: Average Interest Rates of Loans and Deposits in Percentage per Annum

Type of Lender	*Semi-Urban Mabodale*	*Remote Rural Makkaduwawe*
Friends and relatives	0	0
Moneylenders	151	165
Traders	50	0
Bank loans	16	15
NGO loans	22	34
Bank deposits	12	12
NGO deposits	18	12

semi-urban location was the electrification credit for subsidized financing of electrical wiring. Potential borrowers do, all the same, not perceive conditions attached to some institutional credit programs as a notable barrier.

Informal lenders service credit requests for whatever demand exists among borrowers. Sanderatne (1992) argues that the non-availability of consumption loans from the formal sector is a major incentive in Sri Lanka to take loans from informal sources. This could not be confirmed in interviews with borrowers. Banks do extend consumption loans, albeit on a limited scale, such as pawning loans or *attamaru*, friendship loans, where no securities, but only guarantors are required.

Interest Rate Levels. The favorite topic in any discussion on formal and informal lending is the rate of interest. Informal lenders are said to charge exorbitant rates, whereas cheap loans from banks are seen as a way to free the rural population from exploitation by moneylenders. Studies in Sri Lanka generally emphasize the existence of very high interest rates in the informal sector, but Fernando notes that only a relatively small proportion carries an exorbitant rate of interest (1988: 13).

Some authors consider subsidized institutional advances as an income transfer mechanism (Wickramasinghe 1987: 51). Others stress that the interest rate level reflects the risk composition of loan portfolios. The lower the interest rates the higher the probability that low risk investments are undertaken with low economic rates of return and consequently detrimental effects to the economy (Hoff and Stiglitz 1990: 239).

Data from the two surveyed villages in Table 3 show that formal lenders extend loans at rates between 15 and 34 percent per year. NGOs charge higher rates, because they do not subsidize loans. NGOs in the remote village charge the higher rates, since they had to add an extra risk premium for defaults stemming from the prolonged political unrest in this village. The interest rate structure of banks, particularly in the remote location, indicates market distortions: the spread between average deposit and lending rates is too small to operate profitably, especially in the light of higher default rates in this location.

Borrowers from informal sources face a wide range of interest rates. Loans from friends and relatives are interest-free. Traders provide loans to strengthen relationships with customers. Shopkeepers advance small amounts free of interest. The competition for customers is so strong in the small shops in both villages that shop owners are often forced into credit arrangements. The case is different with produce buyers like copra traders. They charge hidden interest in the form of lower produce prices. The interest rate differential between the two villages is due to different products being traded. Many traders-cum-lenders in the semi-urban location are produce buyers. In the remote village, no trader engages exclusively in the marketing of agricultural produce. Some shopkeepers buy rice and dried pepper from the farmers as a side line. The erratic supply and subsistence orientation of farmers in the remote location limits advances against future supply of produce.

Moneylenders charge the highest rates of interest, averaging about 160 percent if calculated on an annual basis. But such calculation distorts the picture. If the loan amount is small and repaid after only a short period, borrowers are willing to pay these rates even when having access to other, but less flexible, credit sources.

Villagers who did not borrow stated that high interest rates of bank loans would explain the popularity of other credit sources. Actual borrowers, however, judged differently.

Timely Provision of Loans. In his comparative analysis of formal and informal finance in India, Nayar (1992: 204) observes that, “The major attraction of all informal financial institutions is their speed in transacting business”. Sapukotana (1975: 42) who also included non-borrowing respondents in his credit survey in the Kegalle District, describes “Opinions on Borrowing from Rural Banks and Moneylenders” as follows: “The prevailing perception of loans from moneylenders was that they are easy to obtain. All other opinions in the brainstorming exercise rank far behind. Rural banks, however, are perceived to be tedious.” The performance of banks in this respect differs. Generally speaking, the lower the interest rate level, the longer the waiting time and the more demanding the requirements that have to be met. The pioneering effort of the People’s Bank, which included advances for pawned jewelry, stands out as a successful innovation in rural finance in Sri

Table 4: Loan Amounts from Financial Agents (in Rs1,000)

Type of Lender	*Semi-Urban Mabodale*	*emote Rural Makkaduwawe*
Friends and relatives	4,324	0,952
Moneylenders	6,042	1,300
Traders	2,866	0,376
Banks	7,707	4,711
NGOs	4,916	1,188

Lanka. Vidanapathirana estimates that pawning loans have become the single most important credit type offered by rural banks (1988: 3). The banks reap the profit, as pawning loans bear high interest rates, as do the customers, who have quick access to institutional advances.

Speedy advance of loans is a common feature of all informal finance systems and another crucial variable that explains the popularity of informal financial intermediaries in rural Sri Lanka.

Respondents from the wider sample, not necessarily themselves indebted, did not mention untimely disbursal or lengthy credit procedures as a major problem of rural borrowers. But asked why many people use sources other than banks, 30 percent in the semi-urban village and 20 percent in the remote location explained this with delayed credit disbursals and lengthy application procedures for institutional loans.

The Size of Loans. The volume of a loan plays an important role in the overall success of a business investment or a consumption loan. The analysis of loan amounts in the Sri Lankan context reveals some interesting insights into the lending philosophy of informal and formal financial intermediaries.

Table 4 demonstrates that moneylenders provide the largest average loan volume of all informal sources. High standard deviation values point to highly variable loan amounts. Loans taken from friends and relatives are the second most important informal source of loans. In both villages the average loan size from this source comes to about two thirds of that of moneylenders. Traders give the smallest loans, especially village shop owners. Shop owners often use credit ceilings. Small farmers, occasional customers, and customers without safe income prospects get smaller advances. Customers with regular incomes, in particular salaried people, get larger loans and are expected to settle outstanding claims at pay day. Farmers are granted longer repayment periods, until they have harvested their crops.

No other formal or informal loan source in the survey villages extends credits of the size of Sri Lankan banks. In the remote village, banks offer average amounts almost four times higher than those of NGOs and moneylenders. Banks apparently have a strong competitive advantage in this respect. NGOs, like the Sanasa credit cooperatives, set fairly limited credit ceilings which vary from group to group. Consequently, bank borrowers do not complain receiving only part of the amount demanded, as is the case with loans from informal intermediaries.

Data from the semi-urban village illustrate an identical ranking of credit sources, but on a higher overall transaction level. The higher loan amounts are mainly attributable to higher incomes and therefore better repayment potential in agricultural and non-agricultural professions. Further, the booming and dynamic economic environment promises higher returns on invested capital.

Repayment Periods. Friends and relatives, moneylenders, produce buyers and shop owners provide the majority of their loans without fixing a repayment date. Generally, when a loan is advanced free of interest, the understanding between creditor and debtor is that the borrower should repay “as soon as he can”. Moneylenders in the remote village do not insist on firm repayment schedules as long as the interest is paid regularly. This practice was also common in the semi-urban location. However, 17 percent of the loans granted by moneylenders in this location had fixed dates.

Banks and NGOs have clearly defined loan maturities. They do, however, readjust agreed repayment schedules if events beyond the control of borrowers affect debt servicing. Average repayment periods of bank loans in Kurunegala and Gampaha are 44 months and 38 months respectively. NGOs, who distribute much smaller loan amounts, operate with shorter repayment periods: seven months in the remote village and 15 months in the semi-urban village.

Borrowers from banks and NGOs, asked whether repayment periods should be different than as stipulated in the loan contract, approve of these repayment schedules. Some respondents even suggested a shorter repayment period.

The views of actual borrowers on repayment periods of formal lenders somewhat differ from those of respondents in the total sample. In the remote location, seven percent of the villagers thought that repayment periods of banks are too short, against only three percent in the semi-urban location.

Securities Required by Financial Intermediaries. Granting credit against collateral that a debtor will forfeit in case of non-repayment is standard procedure of banks. Although some scholars argue in favor of collateral substitutes, down-to-earth bankers remain disinclined to lend without tangible securities. McLeod echoes their concerns:

> The idea of playing with someone else's money is an appealing one: if the borrower's investment project is successful he gains, but if it fails, someone else loses. By requiring security, the lender encourages the borrower in the most direct way to carefully judge the likely success of his proposed investment (McLeod 1992: 251).

However, banks operating in rural areas of low-income countries are often state-owned and have the specific mandate to extend loans to the rural poor. The People's Bank and its network of Cooperative Rural Banks in Sri Lanka are a typical example. Many poor applicants do not dispose of land titles or similar securities and are therefore in danger of being excluded from the institutional credit market. From the opinions expressed in the wider sample of villagers, it becomes clear that the lack of suitable collateral constitutes indeed a major barrier for would-be borrowers. The inability to find securities was cited by 20 percent of the respondents as a major problem and a reason for resorting to lenders other than banks.

Informal lenders ask for securities to a limited extent only. Friends and relatives provide loans without demanding any securities or guarantors. Traders, i.e. village shopkeepers and produce buyers, also operate without tangible securities, although produce buyers lay claim on the future crop. The personal relationship between borrower and lender is seen as sufficient guarantee for repayment of the loan.

But moneylenders in the two villages do demand securities for loans extended, although the percentage that does is far below the figures in the nationwide survey of credit and indebtedness of 1976 when a reported 47 percent of the moneylenders secured their loans with some kind of tangible collateral (Central Bank of Ceylon 1981). In the remote village, the percentage is 25, as against only 16 percent of the moneylenders in the semi-urban village. The items range from bicycles to tape recorders, registration papers for motorcycles and cars to jewelry. From interviews with moneylenders it appears that securities increase the repayment morale of credit customers. The most successful moneylenders in both survey areas were the ones with variable and sometimes sophisticated security arrangements.

Banks resort to a wide mix of security and guarantee arrangements. Provisions differ according to the loan scheme and even for the same type of loan, different branches of the same bank asking for different securities, relying on personal judgement of bank staff rather than on rigid rules.

NGOs operate without collateral arrangements. The Sanasa credit cooperatives outperform other NGOs in terms of business outreach and repayment rates in both villages. Primary credit cooperatives advance loans largely from member deposits. Loans are granted individually. Apart from small sized instant loans, credits are advanced only when two group members guarantee repayment of a credit applicant with their savings deposits.

Other NGOs operate similarly with guarantee arrangements as collateral substitutes. Depending on the level of cohesion in the group, the repayment results differ. Wherever a group is on the verge of disintegration, the guarantor scheme no longer ensures the recovery of outstanding loans.

Guarantor Arrangements Required by Financial Intermediaries. Villagers who were asked why they preferred informal credit sources to banks, cited the difficulty of finding guarantors acceptable to banks, as a central issue (30 percent of the respondents in the remote village and 25 percent in the semi-urban village).

The two guarantors required have to be tax payers or must be in a position to submit an income certificate stating high level public sector employment. It is almost impossible to find such guarantors in Makkaduwawe, the remote village. And even if so, they might not be willing to act as guarantors, particularly for the poor. Against this background, it is surprising to learn from banks how rarely repayment is actually legally enforced from guarantors in case of default. Except for larger loans, banks are reluctant to bear the costs of enforcing guarantor repayments in courts.

The village study underscored the problem of guarantee arrangements. This factor, not considered in a transaction cost approach, is of crucial importance in loan contracts in the two villages. About 55 percent of bank loans in both villages require guarantee arrangements. Loans from credit cooperatives are also mostly secured by guarantors. In the semi-urban village, a sizeable portion of loans from NGOs are small sized instant loans without requirements for third party guarantors.

Conclusions

The comparative analysis of nine loan components of formal and informal financial contracts from the borrower's point of view yields the following results: the physical distance between households and financial intermediaries does not influence borrowers' decisions for or against certain lenders. Possible sanctions in case of non-repayment also do not influence borrowers' preferences. Collateral requirements and, above all, guarantor arrangements are seen as the main barrier to entry into the institutional rural credit market in both survey villages.

No single lender or segment of the two rural financial markets scores well on all nine loan contract components. Banks provide high average loan amounts at moderate rates of interest, with customer-friendly maturities of their loans. They are an attractive credit source for those borrowers who have access to them. Friends and relatives are the definite low cost option for small loan amounts, whereas moneylenders disburse loans quickly but at high interest rates and sometimes only against the deposit of collateral.

NGOs, in particular the Sanasa credit cooperatives, serve their customers well on many counts, but their limits to loan amounts independent of business requirements and fairly high rates of interest compared to other options, limit their attractiveness in the eyes of borrowers.

Future research on the significance of each of these aspects in loan contracts may show the merits of this approach compared to that of the transaction cost analysis as a tool for understanding borrower's preferences of financial intermediaries.

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1. I wish to thank Professor von Blanckenburg for his support and encouragement and the German Research Council (DFG) for funding the project.

2. The term NGO is used in a wider sense and also includes the Sanasa Thrift and Credit Cooperative Societies.

13

Trade Arrangements and Interlinked Credit in the Philippines

Maaike Hendriks[1]

Land reforms and the Green Revolution with its capital-intensive agricultural technology have increased the importance of informal lenders in many low-income countries, including traders of food products, input dealers, rich farmer-lenders, rice millers and store owners. As a result, informal financial intermediaries have received growing attention from researchers and policymakers, particularly in the Philippines (Agabin et al. 1989; Lamberte and Lim 1987; TBAC 1989). However, in spite of the growing number of (predominantly economic) studies, evaluations of the role of the new financiers still lack detailed, empirical data on their methods of working, their relationships with borrowers, and the different socio-economic and cultural contexts in which they operate. This chapter wants to contribute to a better understanding of these methods, relationships and contexts.

For this purpose, I describe credit relations in the production and marketing of vegetables in the central Philippines, taking into account their diversity and contexts. My analysis provides insights into the interdependency of lenders and borrowers, the interweaving of trade and credit transactions, and the cultural and economic backgrounds of the combined strategy of spreading of risks and profit-seeking. It highlights personalized relations of exchange in vegetable marketing, called *suki*, and the flexible ways in which vegetable traders make use of these relations. Socio-economic factors, the normative environment, specific features of commodities and power conflicts affect opportunities and constraints in the vegetable market, and consequently, *suki* as a normative construct of individual traders and farmers, has different meanings.

High risks are common to credit extension in the production and marketing of agricultural products in the Philippines. While neither the commercial banks nor the Philippines' cooperative sector have proved well-equipped for lending to small farmers, the need for production capital has increased considerably due to the introduction of new HYV technology. With the failure of government programs and the withdrawal of landlords from the credit sphere, the informal finance circuit has extended and diversified since the mid 1970s. Traders and processors of farm produce, dealers in farm inputs, and rich farmers, offer production loans, together with a host of local middlemen in the credit chain from village to city and back, replacing patron-client relations with landlords (Sacay et al. 1985; TBAC 1981).

Peasant agriculture faces further risks and uncertainty because of climatic factors, seasonality of production, changes in consumer preferences, and dependency in land use relations. Trade in agricultural products is similarly risky, and costs of transportation, storage, processing and information are high. Earlier studies show that informal lenders reduce risks and costs by operating in more than one market through interlinked deals (Floro 1987; Geron 1989). For instance, a person engages in the sale of farm inputs, the milling of rice, the purchase of farm products, the finance of production, all with the same farmer.

The literature on India is particularly extensive (Bharadway 1985; Bhaduri 1983; Braverman and Stiglitz 1982). Vertical integration appears as a profit strategy and a way of extracting surplus from poor farmers, since the conditions and asymmetry in one transaction are transferred to the other transactions with the same person. One of the few who have analyzed the interlinkage of credit and marketing in the Philippines is Floro (1987), focussing on the strategies and motives of trader-lenders and rich farmer lenders. She argues that the interlinkage is meant not only to reduce the risk of defaults by replacing the collateral, but also to control the market channels of food commodities and to make profits at the expense of small farmers. In return for the production credit, a trader makes a claim on the produce, and at a lower price than the prevailing market price. Mark-ups on farm inputs and low prices for farm produce (also labor services are sometimes included), contain hidden forms of interest, as opposed to high nominal interest rates common to other forms of informal moneylending in low-income countries (Floro 1987; Geron 1989).

Although these studies on market interlinkage give valuable insights into the lending strategies of traders, they leave many questions unanswered, such as those regarding the influence of the socio-economic context on the interlinkage mechanisms and the long-term and short-term credit relationships, not only between traders and farmers, but also between the various traders in the market chain. In the Philippines these relations are institutionalized in the form of *sukis*, personalized socio-economic relations through which transactions are interlinked, providing the elements of trust and patronage on which the linkages are based and enforced.

1. I want to thank Willem Wolters for his valuable comments on earlier versions of the paper.

Vegetable Marketing on Cebu Island

The following brief analysis of the *suki* system is based on a study of traders in vegetables on the island of Cebu. Fieldwork was conducted from November 1990 to October 1991, partly in an upland vegetable production area and partly on the central market in Cebu City, called Carbon market. Additional research on the farmer-borrowers' point of view is still needed to give a more complete picture.

In a mountainous area of the island, a variety of highland vegetables, including cabbage, carrots, beans, chayote, green onions, sweet pepper and potatoes, are produced with large amounts of chemical fertilizers, pesticides, insecticides, fungicides and plant vitamins. It is the main supply area for the Cebu City market outlets. Since 1986 Cebu City, with 600,000 inhabitants, has been a rapidly growing city, second to Manila (the surrounding urban area, Metro Cebu, counted 2,6 million people in 1990). The city functions as the main distribution point for the central Philippines, the Visayas, consisting of the islands Cebu, Negros, Panay, Bohol, Leyte, Samar and Masbate, as well as for parts of Mindanao, the largest island in the archipelago.

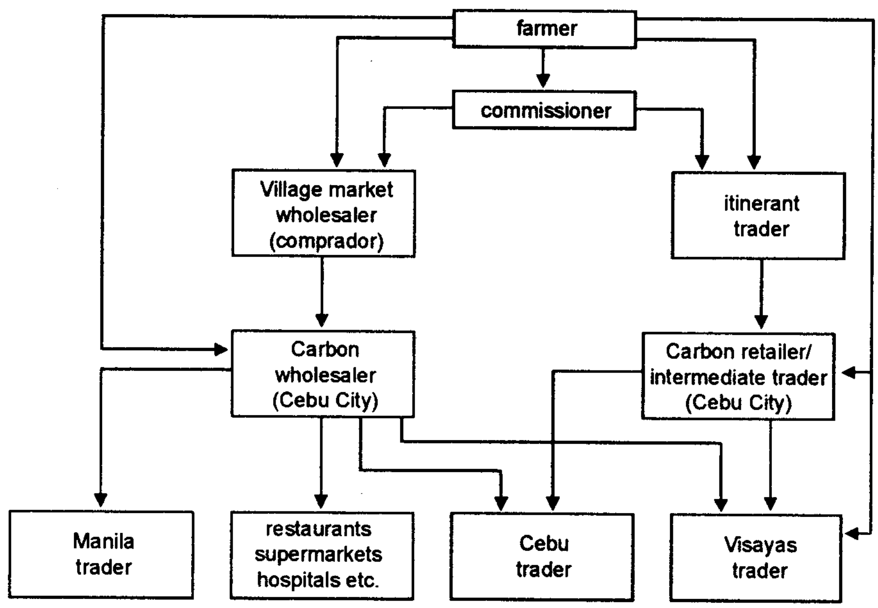
The marketing channels for vegetables are vertically integrated from producers to various types of intermediate traders, wholesalers, retailers and finally consumers all over the Visayas (see Figure 1). In the village, farmers and commission agents supply vegetables to wholesalers, called *compradors,* and small itinerant traders. The commission agents play a role in the collection of the products and the monitoring of the fields. Like *compradors,* many of them also furnish farmers with production loans. Some *compradors* stay in the village market to concentrate on buying, while the search for and the maintenance of personal relationships with urban customers is left to their city partners. Other wholesalers transport the vegetables themselves and supervise the sales in their stalls in Carbon, having no trusted agent there. The itinerant petty traders take their merchandise to the city, and sell it on the streets in front of the market, to retailers, other street vendors, or consumers.

In Carbon market, located in the center of Cebu City, the wholesalers, retailers and street vendors have their own section. Large traders receive telephone orders from regional wholesalers. Occasionally, Manila wholesalers visit Cebu to buy vegetables.

The last ten to twenty years have seen a boom in vegetable production, and the number of traders in the village as well as in Carbon has increased steadily. At all levels in the market chain variations in scale can be noted and competition has increased. One major change is that a growing number of farmers have started selling vegetables directly in Carbon market, while Carbon wholesalers occasionally rent a truck to buy vegetables in the village.

The production and distribution of perishable vegetables involve specific risks and costs. Highland vegetables need specific climatological and soil conditions, found in only a few areas. The production area in the south of Cebu is the nearest to Cebu City, but still about 120 kilometers away. The products are vulnerable to spoilage and damage and have to be transported to the city as soon as possible. Packed in baskets they are brought to Carbon market on cargo trucks, and from there by push carts, jeeps, busses and ferries to retail markets. The production of vegetables involves investments in seeds, farm inputs and labor, which most

Figure 1: Cebu Vegetable Market Channel



farmers can not finance without making use of loans from traders and landowners. Although the vegetables can be cultivated the whole year around, the demand is subject to changes in consumer preferences. Vegetables are not a staple food on the Filipino menu, but are a luxury food, added to rice, corn and fish. Low-income households consume the cheaper lowland varieties of vegetables. As a result, demand is fluctuating and prices can drop even below production costs. On the other hand, sales can suddenly pick up when other supply areas are struck by typhoons, floods or other natural calamities.

In the distribution of vegetables the traders take the roles of financier, assembler and transporter. Due to the high risks and fluctuations in available capital, people change roles from wholesaler to retailer, commission agents, *comprador,* even moving out of business altogether. The wholesalers in the Cebu vegetable business appear to control certain market channels, although no monopoly exists. Through partnerships with relatives they have a grip on prices and supplies at certain times of the year, and they are able to explore the market and secure contacts elsewhere. Most importantly, they secure supplies by providing the capital for vegetable production. Major problems for traders are shortage of capital, falls in demand, and growing competition from newcomers. Therefore, they link transactions at the supply side as well as the selling side through credit, using their own capital as well as that of others. The traders not only supply production loans, but credit is the pivot of trade as well. Credit lines reach all the way from Carbon market to the village and to retailers and consumers on neighboring islands. Two types of credit can be distinguished. One is delayed payment or payment in installments from buyer to seller of produce. This occurs at all levels in the chain, from traders to farmers and from buyers in Carbon to wholesalers or retailers. The other type of credit is advance payment to producers, in the form of farm inputs or money to buy them. Central aspects in the linkage are the agreement on repetitive delivery or purchase of products, and the claim of the financier to grade the quality of the products and to set the price.[2]

Suki Relations as Enforcement of Market Interlinkage

In general, *suki* means regular customer. Philippine *sukis* are pictured as a system of personalized dyadic relations, or long-lasting contractual arrangements (Szanton 1972; Davis 1973). The term refers to the relationship itself, but also to both the trading partners involved, buyer and seller. Producers, retailers, wholesalers and consumers alike, all can be *sukis.* In the simplest form, one party provides the other with a secure outlet for her products and access to capital, and the other is promised a steady supply by selling exclusively to her.[3] The personalized nature can also be expressed in services, small gifts and financial support for funerals, weddings and the like. The relationship has to be developed over time, for both parties have to show mutual trust.

In the vegetable trade, the main purpose of establishing *suki* relationships is to secure regular supply and disposal of produce. *Suki* implies living up to norms and values, expressed as *utang na loob,* a moral debt of gratitude, and *pakikisama,* the maintenance of smooth interpersonal relations. Also ritual kinship ties like godparenthood, *compadrazgo,* are linked to *suki* contracts and serve to enforce the long-term commitment of the participants (Davis 1973). Some authors relate *suki* to a general notion of a "right to survive", a guarantee of safety and stability (Szanton 1972). In what is generally referred to as "moral economy", *suki* networks are a kind of redistribution system and are mutually beneficial.

However, Russell (1987) has challenged the mutual advantage of *suki* relations, introducing the aspect of power in the analysis of market relations. She argues that individual traders and farmers do not freely and independently enter *suki* relations. Being completely dependent on others for resources, many have no other choice than to accept low prices from their *sukis*. Both lines of interpretation will be further assessed in the following.

In Cebu the moral consideration of "a right to survive" and the social content of relations do play a role in the village as well as in the city market, but only with regard to *sukis* from the same village of origin, friends, relatives and neighbors. Mutual trust turns out to be an important aspect of *utang na loob* and *pakikisama*. The spreading of risks, in particular concerning defaults, is indicated as a general reason for long-lasting marketing contracts. But in my view there is a more important function of *suki*: the provision of credit is a strategy to bind people in order to ensure access to outlets or supplies. Thus *suki* is an instrument for linking transactions. As will be shown in the following, the asymmetry and power within *suki* relations are useful instruments for big traders.

Variations in Suki Relations

In the vegetable trade, it is difficult to generalize on the content of *suki* relationships. Large traders use the

2. Trader lenders who own land link these credit-cum-market transactions with labor and land relations.

3. Most traders as well as most farm household members involved in the selling transactions are women.

bonds to stabilize their business through interlinked transactions with farmers and commission agents. Relations with suppliers are usually long-lasting, because of the inability of the latter to repay the loans.

The smaller traders in the production area and in Carbon establish *suki* relations with a changing set of customers, depending on their resources and their capital flow. These relations are generally short term, and frequently end if a loan is repaid.

Characteristic of the vegetable market chain in Cebu is that different kinds of *suki* relations between farmers and traders can be distinguished. Some *sukis* are considered loyal and trustworthy partners, others are just called “acquaintances”. In Carbon market many buyers “just shop around”, selecting what they like most. Here, the term *suki* is used in a very loose manner, and the things that are exchanged vary considerably. If a producer receives all farm finances from her *suki*, she is obliged to sell all her produce to the *suki*, accepting the price that is offered. In cases where only small amounts of credit are involved, or none at all, there can be fierce bargaining over prices.

If they have had loans in the past, but are not indebted at present, farmers can look for other buyers. A buyer can try to keep the farmer bound to her by letting her share in price increases, and by buying low quality products.

In case a farmer and a trader have an equal economic status, a long-lasting relationship can be established with equal benefits to both; the same applies to buying and selling traders. Especially when no credit is involved, and the partners do not like to haggle over prices and quality, *sukis* can be convenient. I found no trader in the market chain who had only one *suki*. Individual traders establish different kinds of *suki* relations with different customers under different circumstances. It is common to reserve a portion of one’s merchandise to a limited number of “real *sukis*” and sell the rest to highest bidders.

Case 1: Sonja, an Intermediate Trader in Carbon

Sonja, together with her sister, has a stall in Carbon market. She gets her supplies from itinerant traders and farmers and sells to two traders from outside Cebu, two small restaurants and to small retailers and street vendors. Several of her buyers and sellers have fixed days of delivery or purchase. With others she does business on an irregular basis.

She very much values her supplying *sukis*, because she needs a steady group of reliable suppliers. She services some of them with money to buy farm inputs, small gifts, money for a bus ride, a lunch, or loans without interest if a calamity occurs in the family. She considers it an investment that will pay off and admits that she and her *sukis* make use of each other. “I use them, they use me”. Some of her suppliers sell to competing traders in Carbon as well and Sonja buys from them only when the quality is good enough to resell the goods herself. She still calls these suppliers her *sukis* because when supplies are scarce they divide their produce among her and neighboring traders.

Her buying *sukis* frequently ask to postpone payment. In return she imposes a price mark-up, and expects them to buy from her when selling goes slowly. Even then, when demand drops, she is stuck with left-overs. When supplies are scarce, she herself makes sure to reserve part of her produce for her most loyal buyers, selling the rest to highest bidders.

Towards her customers she maintains “a balanced attitude”: “You give them good prices and treat them nicely. But I also make them understand that I can neither buy vegetables if they do not pay, nor give them a discount when my other *suki* needs the money”.

Transactions on a Cash Basis

Besides buying and selling through *sukis*, transactions without *sukis* occur at all levels in the market chain and mostly on a cash basis. First, there are farmers who receive production credit from landowners or have their own capital, and may sell to highest bidders. Because they are not sure when demand is sluggish, they usually have one *suki* on an installment basis.

Second, there are petty traders, travelling from the village to Carbon two or three times a week, who sell to highest bidders. They adapt their prices to those of the big traders; they bear high risks of spoilage and losses, since they have no resources to bind customers with credit services. They are dependent on finance from others and usually buy from suppliers on an installment basis. Occasionally they also sell on installment to some people, hoping this will be the start of a long-term *suki* relation. The risk is high, though, because most customers in Carbon already have their own *sukis*. Most of these itinerant traders are women, who started petty trading to add to the household income. Some have been in business their whole life, and are not able to expand because of a lack of capital and a long history of indebtedness to suppliers.

Thirdly, there is the art of “smuggling” by farmers and traders, secretly selling products to someone other than their regular *suki*, in order to get a higher price. For many of them the linked *suki*-transactions are a strategy of security, even survival. But especially when supplies are low, people tend to “forget” their *sukis* to gain some extra profit. The cheating can take place at both ends of the chain. There are limitations to “smuggling”, for one has to be careful not to endanger one’s *suki* relation. Traders who have invested scarce capital in the *suki* can get angry. Cases of violence, for which the south of Cebu is well known, are due to cheating between *sukis* and quarrels over prices.

Finally, there are traders in Carbon who do not extend credit, and avoid *suki* relations because *suki* suppliers are easily tempted by the high prices due to growing competition. Also, at the selling end, they prefer to do business on a cash basis, taking the risk of not selling all their stock rather than of not getting paid. Many informants indicated this as a new strategy in the business.

Suki as an Instrument

It is remarkable that many traders refer to *suki* relations as market strategies, not so much stressing the spreading of risks or a reciprocal security mechanism, but the profit aspect instead. Through the extension of credit one tries to control supply and prices, to gain a good bargaining position, and to make profit. The big city traders have the best position, dictating prices to indebted suppliers and making deals with buyers in Carbon market. Although there are target prices for the various vegetables, actual prices are adjusted to individual *suki* relations and credit services, and the risks of falling prices can be transferred to buyers and suppliers. Small farmers and small traders have little room for manoeuvre, since they depend on the capital of their *sukis*.

The fact that the term *suki* indicates *utang na loob* values for both trading partners is rather confusing, because many relationships are asymmetric and characterized by subordination and patronage. Small farmers are seldom in a position to return favors or pay off a debt. It is the lender who uses his social power to maintain the relationship, and gets the highest profits.

It is especially the traders with a variety of business interests who have enough capital to finance and control many *sukis*. Further, six or seven wholesalers in the village market and about ten in Carbon “group together”, as they call it, to make price agreements when selling prices or consumers’ demand are dropping or expected to drop. Common practices are also price deals to mislead other traders or farmers, including their *sukis*, or “pilfering” *sukis* from others.

The main advantage of maintaining *sukis* with vegetable suppliers, farmers as well as intermediate traders, is the long-term effect. Throughout the year, a certain turnover is assured. But what the traders anticipate are sudden price upsurges in the city market, and to profit from them through their *sukis*. Profits are highest when the market suddenly picks up and traders can dictate a low price to supplying *sukis*. Which of the intermediate traders will share in the profits, depends on the credit agreements, as the following case will show.

Case 2: Nelia, a Village-Based Wholesaler

Nelia is a *comprador* in the village market and a benevolent *suki* for her farmer-suppliers, to whom she provides farm inputs and financial support. Her brother-in-law is her partner in Carbon. He sells the vegetables she sends him to buyers from all over the Visayas on a credit base, or sends orders he pays once a month by money cheque.

One day her partner sent her a large order without the capital to pay it. Her own money was tied up in loans to *suki* farmers and commission agents, and she had to borrow from a friendly commission agent against an interest of 20 percent, to be paid in 30 days. In return, the agent was allowed to act as intermediary between Nelia and her supply *sukis*, getting a P2 higher commission than the regular one of 0.50 per kilogram. A lot of bargaining took place, but Nelia was not willing to lose on this order. She therefore transferred the costs of the extra link to her supplier *sukis* by paying them a lower price. These had to accept because of *utang na loob* for receiving the farm inputs and the length of the *suki* relation. It was easier for Nelia to roll off the problems to the farmers from her native village than to ask payment from the buyers in Carbon, on whom she and her brother-in-law had to rely in times of oversupply.

In the *suki* chains the wholesalers in Carbon are strategically positioned, maintaining *sukis* on both the supply and distribution side. Farmer and trader *sukis* are valued as stable suppliers of products, whereas buyers are valued for regular purchases. With these *sukis* the element of patronage is absent, and the exchange of favors is under continuous negotiation, as the following case will show.

Case 3: Edgar, a Carbon Wholesaler

Edgar is a wholesaler in Carbon market, who daily receives about 10 to 20 baskets of 120 kg vegetables each, from his partner in the village. He has a good reputation among the regional buyers visiting Carbon market, and has established good *suki* contacts in only five years in business. One of them is a trader from the neighboring island Leyte, who once every three months visits Edgar to discuss the vegetable business. Edgar relies on him in times of high supply and slow selling, so he extends him credit in the form of delayed payments. Additionally, he makes sure that this customer always receives a share of his produce, even if there is not much of it. However, one time after a typhoon in Luzon, the vegetable supply area for Manila, a wholesaler from Manila approached Edgar to buy nearly all his stock for high prices, and Edgar accepted the offer. He was eager to start trading links with Manila, and refused to service his Leyte buyer. The latter "had to understand" because of his *utang na loob*. But Edgar was careful not to endanger the bond any further because he needed this *suki* later, as happened when the Gulf War started and selling was very slow.

Concluding Remarks

To engage in vegetable farming and marketing is risky and costly, but profitable, the actors adapting their strategies for long-term and short-term gain and security. In this context, credit is an important tool, not only to provide production capital but also to secure supply and outlet channels.

One result of this study is the demystification of the overromanticized picture of *sukis*. *Suki* relations are a suitable mechanism for credit contracts, especially when traders want to link credit transactions with fixing prices and securing supplies. The relationships provide trust as well as the notion of mutual interest: "we use each other". *Suki* is used as an instrument in the search for security and certainty, but in a flexible way to optimize gains in the trading business. *Suki* relations should not be seen as fixed models for behavior, but something that is subject to continuous negotiation, since all the actors involved have their own interests and different opportunities to enforce them. Because of market competition, *sukis* are valuable, but at the same time there is a trend towards diversification of *suki* relations, even within the networks of one trader or farmer, as well as a trend towards more businesslike cash transactions.

Suki is most readily manipulated by the powerful who use their status and the claims of morality to enforce market arrangements. The profitable aspect lies not only in hidden interest rates or price margins, but also in the long-term effects of gaining from market opportunities. Wholesalers in Carbon market have *suki* links with both the supply and outlet side, and are constantly trying to optimize their business by using and misleading their own *sukis* and those of others. Unequal bargaining positions exist where farmers and small traders depend on credit contracts. Their only opportunity for short-term gain is to smuggle and by-pass their *sukis*, which has become possible because of the increased number of competing traders.

The fact that this happens at all levels in the market chain, puts the *suki* values of moral debts and gratitude in their proper perspective. It must be noted, however, that smuggling occurs only occasionally, since one has to be careful not to jeopardize the relationship with the financiers. Farmers and petty traders have less room for manoeuvre than wholesale traders. The wholesalers in Carbon market are capable of selling large quantities on credit to customers with major capital sources, with agreed payments two or four times a month. But the small traders deal with *sukis* who continuously demand credit and fail to pay back. They, therefore, maintain only few credit lines, or none at all. Especially the new traders in the market are strict, preferring cash transactions and avoiding *suki* arrangements with unreliable buyers. They do need sufficient capital and offer high prices as extra services. The street vendors do not have such financial resources. They live under constant risk of bankruptcy and can only invest their time and labor, moving from one selling spot to the other, almost 24 hours a day.

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14

The Agrarian Question of Financial Landscapes: The Case of Ambon

Otto Hospes

Every agro-ecological situation implies a specific pattern of production and a particular combination of savings, borrowing and insurance behavior of producers. Likewise, the strategies and services of agricultural traders and other financial intermediaries depend very much on the agro-ecological situation. Soil conditions, cropping patterns, water supply and drought might have a strong impact on the nature and number of financial services in rural areas of developing countries. Predictability, periodicity and diversity of agricultural production directly affect decisions of producers related to savings, borrowing and insurance.

Platteau and Abraham (1987) argue that credit has evolved as a hunger insurance mechanism in fishing communities in India as a result of daily fluctuations of fishing incomes: a fisherman with surplus income lends money to his less fortunate fellow fishermen, who are supposed to help him in return when short of money and food. Southwold (1990) describes how coconut evolved as the major form of collateral for credit for securing food in a period of drought, failure of the paddy crop and restricted money circulation in rural Sri Lanka. The regular and relatively predictable income from coconut proved a solid base for copra traders and shopkeepers to supply credit in cash or goods to farmers. Borren (1986) reports the existence of different flows and forms of credit in three ecological zones in the Great Scarcies Area of Sierra Leone, each characterized by a particular cropping pattern. Van Nieuwkoop (1986) finds that in Malaysia, “Paddy farmers who have an income that is generated only once or twice a year use more informal credit than rubber farmers who have a much more regular income” (p.60).

These observations would lead one to expect that the relationship between particular agro-ecological conditions and savings strategies, credit transactions and redistribution of risk, has been the subject of much research and policy debate. However, only a few empirical studies have explored this relationship, and it is questionable whether their findings have influenced policy debate at all. Of course, this question is only one of many issues which arise in the field of rural finance, that is, the complex of decisions of individuals and groups regarding insurance, savings and credit; services of financial intermediaries; and existing relations and conditions that affect these decisions and services (cf. Schmidt and Kropp 1987).

However, even at a time when the role of agricultural credit as a development tool was widely discussed, this “agrarian question” was hardly addressed (AID Spring Review of Small Farmer Credit 1973). Yet the considerable difficulties in defining “the small farmer” would have provided ample reason to do so. Rice (1973) mentions that, “no single satisfactory definition is available to distinguish small farmers from medium and large farmers in all parts of the world” (p.3). However, this conclusion was not followed by a call for a more contextual approach of the credit problematic that takes into account location-specific ecological and agro-economic environments. Instead, Rice reassures us that:

> The small farmer syndrome is generally recognized -- families owning or leasing small, often discontinuous plots and trading in a local village market without access to supplies and services essential to modern technologies, without expectations of living much above the subsistence level, and without political influence. The problems are sufficiently similar to justify a common research program and look for transferable lessons (Rice 1973: 3).

Only in a rather casual way he finally adds, “But heterogeneity must be recognized: a 20 acre rainfed maize farmer on a Brazilian hillside is a different economic animal than a half acre Bengali paddy farmer on the flood plain of Bangladesh” (Rice 1973: 3). Yet the notion that specific agro-ecological conditions, and agro-economic changes, explain variation of savings and borrowing patterns among the heterogeneous farm households, has not been worked out. Neither do more recent policy-oriented studies suggest taking a close look at agro-ecological conditions and savings and credit behavior. For instance, Quinones’ APRACA paper (1985), called “An Overview of Agricultural Credit Systems in Selected Asian Countries”, concentrates on agricultural credit policies and institutional systems for agricultural credit. He does make a very general distinction between cereal production and other sub-sectors of agriculture in Asia, but even this distinction is not part of his further analysis of appropriate credit policies.

This paper addresses the agrarian question of financial landscapes of developing countries from both an analytical-methodological and descriptive-analytical point of view. My first objective is to explain why this agrarian question has been dealt with so poorly in policy discussions on agricultural credit and rural financial markets. This poor handling has a wider background and is one of the consequences of the institutional and instrumentalist bias of participants of these discussions. My argument is that integrated approaches are needed that look at the impact of location-specific agro-ecological conditions on savings and borrowing behavior in a double sense, that is, strictly speaking and in relation to (changing) legal, institutional, social and economic contexts. The use of the metaphor of “financial landscapes” is meant to stimulate a more environmental approach to borrowing, saving and lending behavior of institutions and individuals[1].

My second objective is to describe and analyze the impact of agro-ecological conditions of rural Ambon, Indonesia, on savings strategies and credit transactions. This island is characterized by a particular combination of food and cash cropping that has strongly affected social life and economic development. Of course, one cannot assume simple and straightforward cause-effect relations. The agro-ecological environment is just one of the many contexts of savings and credit transactions, which in turn are just some of the many types of human interaction. Therefore, my case study of rural Ambon includes descriptive analyses of how political-institutional, economic and socio-legal developments have weakened, reinforced, transformed or differentiated the impact of agro-ecological conditions on savings and borrowing strategies.

Out of the Question: Agrarian Contexts of Savings and Credit

In this section I review the policy discussion on small farmer credit and its follow-up on the construction of sustainable rural financial markets. Both discussions are characterized by more or less similar questions and perspectives, such as the price of credit and its impact on the effectiveness and efficiency of supplying financial services to the poor.

In the early seventies the United States Agency for International Development (AID) collected project information on the history of its investments in agricultural credit since the early fifties. These project files provided the basis for the voluminous Spring Review of Small Farmer Credit (1973). The collection of source material focussed on three principal themes: “(1) the role of institutional credit in small farmer development, (2) the major institutional alternatives for delivering small farmer credit, and (3) certain policy issues, such as interest rates, that appear to be critical to the success of these programs” (Rice 1973: 5). The general idea, with respect to agricultural development, was that credit is supplied in the first place to be used for the purchase of high-yielding inputs, so that small farmers can overcome their poverty themselves. As a result of the strong emphasis on credit as a tool to upgrade the small farmers’ sector in the “general direction of modernization” (Geertz 1962), little attention was paid to the diversity of agro-ecological contexts and its implications for credit programs. Even worse, the debate on the role of credit was based on a specific type of agro-ecological context. The most important features of this context are: the small-farmer population is primarily concerned with the production of food-cum-cash crops (like e.g. rice). The agricultural cycle is characterized by regular, but inadequate and insecure food production, with one annual harvest preceded by a difficult period of shortage of food and/or money. This agro-ecological context has seldom been questioned in the debate on the role of agricultural credit, and has been wrongly assumed to be a kind of constant. For a number of reasons, the rate of interest on loans, rather than different and changing agrarian contexts, became the main variable in this debate.

The Price of Credit

During the AID Spring Review (1973) the growing concern about the need for and policy of providing loans at low rates of interest to small farmers was strongly expressed. The Review triggered a long series of publications that disqualified this cheap credit policy as a “grant theory” that was neither of help to small farmers nor conducive to building sustainable and efficient financial intermediaries. The case against cheap credit shows a high internal consistency and is easy to summarize: low rates of interest on loans from specialized farm credit institutions (SFCIs) create an artificial credit demand among the well-to-do. Bank managers and credit agents are very much inclined to meet this demand and discriminate against small farmers: they face low incomes from low rates of interest and ration their loan portfolio because it is much cheaper to provide one large loan rather than a hundred small ones. The distribution of cheap credit implies great losses to the SFCIs: default is high because cheap credit is easily mistaken for a grant. The demise and resurrection of SFCIs through new financial injections is the result. The limited possibilities of mobilizing rural savings, as a result of low rates of interest on savings, further reinforce financial dependency from above.

1. For a broader assessment of the metaphor of financial landscapes: see Bouman and Hospes, chapter 1.

Although the case against cheap credit has become the basis of a follow-up discussion on the construction of sustainable rural financial markets, the case itself is quite narrow and needs to be critically reviewed from both actor- and environmental perspectives:

First, the case seems to be based on the assumption that rural people behave more or less according to a universal and uniform (high) price-elasticity of the supply and demand of capital. However, the rate of interest is only one of the determinants of savings and borrowing behavior: many rural people associate banks primarily with complex procedures, hard collateral requirements, many photocopies, limited opening hours, bribery and so on. Therefore, one might better speak or calculate -- if quantifiable at all -- in terms of “service elasticity” (cf. Huppi and Feder 1989: 49) and expect the significance of such elasticity to be great for rural poor. Even in economic terms, when we take total borrowing costs into account, it is hard to consider the rate of interest as the major determinant of savings and borrowing behavior. Also, the inverse expectation underlying the case against cheap credit, that rates of interest at market levels would make banks eager to lend to small farmers, is over-optimistic. It expects banks to do the impossible, as McLeod argues elsewhere in this volume (p.87): “banks simply are not good at competing for this kind of business.” Even worse, the differential response to changes in rates of interest and the relative importance of those rates versus other financial services has been very poorly researched and documented from an actor perspective.

Second, the case against cheap credit has long directed the attention of policymakers and researchers away from the different and changing environments of rural financial intermediation (cf. Schmidt and Kropp 1987: 49-55) and how these environments affect people’s decisions on monetary and non-monetary forms of savings, borrowing and repayment. Fortunately, many rural producers seem to have developed comprehensive views and practices with respect to official credit programs, agricultural price policies and monetary instability. Two examples suffice.

The first example concerns agricultural price policies. Although it is recognized that the cheap credit policy is meant to compensate small farmers for low agricultural prices, this insight (Adams 1986) has long been ignored by national governments and has hardly been further developed in research on institutional sustainability of rural financial agencies. Gentil (1991), who briefly describes the background of quasi-groups of borrowers and their default behavior, suggests that peasants have a more comprehensive view in this respect: “In the eyes of the peasants, it is nothing more than a simple form of recovery from the outside of a part of the surplus that has been withheld from them through taxes, the price system and other forms of levying” (p.4, my translation).

The second example is the disregard of one of the main features of many developing economies: high inflation (cf. World Bank 1989). Inflation makes the almost axiomatic recommendation for savings mobilization programs contestable: high inflation implies a sharp reduction of purchasing power of those who save in cash. When inflation soars, conversion of savings in cash into savings in kind might result. However, the background and motives for conversion of money into valuables, grain, house construction material or cattle have been largely ignored, or disqualified as hampering development of the financial infrastructure:

> Even the poorer members of the population, surprising as it may seem, have savings which they hold either as real assets or in monetary form. Usually, however, their savings are not placed at the disposal of others for investment purposes and, if the households have no investment opportunities, remain unused, or are even squandered for economically and socially dubious purposes. At the same time, there are individuals with investment opportunities and a desire to invest who, however, lack the financial means because their own resources are insufficient. The lack of capital for investment in the presence of unused capital which could be invested is a sign of an underdeveloped financial infrastructure (Schmidt and Kropp 1987: 7).

For these poorer members of the population, however, savings in kind make sense when facing high inflation. Besides, savings in kind serve as a protection against family claims or as a bank of last resort in case of emergencies. It is misleading to emphasize the need of savings mobilization in cash and to blame people who save in kind for the underdevelopment of a financial infrastructure, when these same people simply adapt their decisions to insecure economic and demanding social environments.

My conclusion is that the debate on agricultural credit and rural financial markets has not only distracted attention away from the significance of agro-ecological conditions, but has also largely failed to assess the differential impact of (changing) political, economic and socio-legal conditions on borrowing and lending behavior. Not surprisingly, the discussions on the role of agricultural credit and financial institutions as instruments of development have constantly fostered the need to “look for generalizations” during the last two decades (cf. Rice 1973; Adams and Fitchett 1992: 355), calling for sound policies or winning formulas of financial intermediation that should preferably be appropriate under any circumstance. Because of this call for generalizations, descriptive case studies that include contextual analyses of financial intermediaries (Platteau and Abraham 1987; Bouman 1989; Southwold 1990) are easily neglected. Maybe even worse -- at least from the point of view of policymaking -- is that the search for the winning formula erodes abilities and knowledge to develop location-specific approaches to location-specific problems.

The now popular call for "sustainable" or "durable" financial markets among policymakers and policy-oriented researchers might have similar effects. My impression is that sustainability or durability are usually treated as an "internal" affair of a financial institution or market. Such an approach is to close one's eyes to changing and location-specific conditions of financial intermediaries, at the expense of exploring ways to increase their diversity, flexibility and adaptability.

From Institutional to Integrated Approaches

To circumvent the inherent shortcomings in the discussion of the price of agricultural credit and the need for sustainable rural financial markets, the development of more integrated approaches to savings and credit behavior is needed. An integrated approach does not reduce rural actors to interest-led supernumeraries, but recognizes different types and combinations of savings, borrowing and lending preferences. It combines actor and institutional analysis, but leaves open whether and where the demand and supply of different financial services meet. One of the main reasons to study savings and credit transactions from both actor and institutional perspectives is that "not every financial decision of rural households and enterprises leads directly to a demand for the services of financial institutions" (Schmidt and Kropp 1987: 25). An integrated approach to savings, borrowing and lending behavior includes analysis of the background and motives for non-monetary transactions and the conversion of cash to kind and vice versa. An integrated approach does not analyze savings, borrowing and lending decisions of actors and institutions in isolation, but in relation to (changing) legal-institutional, social-economic and agro-ecological environments.

The Significance of the Agro-Ecological Complex of Rural Ambon

Since the sixteenth century the economy of rural Ambon has been characterized by a specific combination of subsistence-oriented and (world)market-oriented production. Sago and fish are the most important subsistence crops; cloves are the main cash crops. This combination has strongly affected processes of monetization and commoditization under different political-economic systems. Somehow, the early exposure of the Ambonese population to merchants and the proceeds of clove sales did not result in a smooth and quick incorporation into capitalist world economies. Although Ambon island has been part of national and international trade networks for centuries, it was not until recently that for many rural people making money has become more important than gathering subsistence goods like sago and fish. Knaap (1981a) argues that the traditional economy, in particular sago and fishing, remained the backbone of economic life in Ambon in spite of the introduction of clove cultivation and linking-up with the world economy in the sixteenth century. One might say that agro-ecological conditions have retarded and filtered processes of monetization and commoditization of rural Ambon and many other parts of the Moluccan archipelago.

To get an insight into the "internal" mechanisms that have affected these long-term and uneven processes, I will describe the main features of the agro-ecological complex of rural Ambon and its general implications for food security, housing, organization of labor, intensification and marketing of produce. This suggests an outline of the basic patterns of non-monetized agrarian relations and forms of cooperation that have regulated the demand and supply of labor for traditional house construction, food collection and harvesting of cloves. One further step is to explain the absence of credit (in monetary form) as a hunger insurance mechanism, credit as a labor-tying device and -- until recently -- credit as an output-securing device (cf. Platteau and Abraham 1987). Admittedly, this descriptive analysis from "within" results in a somewhat static and one-sided explanation of retarded "processes" of commoditization and monetization in rural Ambon. However, it might well complement the more historical description of "external" mechanisms of the same retarded processes in the next section. Both sections together form an excellent starting point for describing the social dynamics related to the recent erosion of non-monetized agrarian relations, and the sudden increase of credit needs and the emergence of savings and credit groups, and production-specific credit transactions as output-securing devices -- all in monetary form.

Soils and Silviculture

In contrast to Java, the soils of the Ambon islands have limited fertility, which reduces technical options for agricultural development. According to Knaap (1981b), Ambonese soil is not appropriate for export-oriented agriculture on a large scale. He concludes that silviculture, that does not affect the soil fertility in a dramatic way, offers the best opportunities given the environmental constraints. Moreover, the planting of trees enables soils to recover from the cultivation of tuberous plants that exhaust the soil rapidly. In the ecological system of

Ambon only clove and nutmeg trees were successfully introduced, primarily because they seemed to fit soil conditions.

The most salient feature of the agro-ecological complex of rural Ambon is the forests that cover nearly the whole area. These forests have a great cultural and economic significance. In fact, rural Ambon might be conceived as a silviculture including different sets of rights on trees and land as main determinants of social and economic life (cf. Benda-Beckmann 1990). The production features of the two main crops, cloves and sago, are a second important element of the agro-ecological complex that has far-reaching socio-cultural and economic consequences. In this article I concentrate on the specific production features of these main crops, together with their contrasting roles as cash or subsistence crops.

Cloves are a perennial crop that takes five years to reach maturity. However, this is not the beginning of a rather constant and predictable pattern of annual or two-monthly yields, such as with coconut production. On the contrary, the production of cloves is irregular and almost unpredictable. Godoy and Bennett (1990) note that, “cloves have a production cycle in which bumper harvests occur every three to four years, with insignificant yields between bumper harvests” (p.63). In addition, large variations in production can occur in a small area, even within village boundaries. The clove buds ripen between August and December, but again there is much variation in dates. Picked clove buds, however, properly dried, are not perishable and can be stored for years without losing much of their aromatic quality.

The production features of sago trees differ sharply from those of other food crops like rice and maize. Sago trees have no annually recurrent growth pattern. After 20 to 30 years sago trees have reached maturity. Mature trees are not harvested annually but simply cut down to collect the pith of the tree. Properly processed sago pith can be kept for many years. Another important feature of sago is that mature trees can be harvested all through the year and the collection of sago is, therefore, considered part of the gathering economy (Taale 1988: 5).

Sago is a subsistence crop involved only in regional barter networks (Taale 1988) and not a commodity -- such as rice or maize -- to be sold at regional or national market places. In contrast to sago, cloves are a pure cash crop initially exclusively produced for the world market. During the last 40 years cloves have been produced mainly for the national Indonesian market as an ingredient of the very popular *kretek* cigarettes. The contrasting roles of cloves and sago together explain the dualistic or “janus-faced” economy of rural Ambon.

Food Security and Housing

The basic food products of the Moluccan archipelago, sago and fish, guarantee a minimal subsistence basis in food and housing. The sago palm in particular is a blessing: its pith is used to make porridge and bread. The long nerves of the palm and its huge leaves are useful for building walls and a roof that need no repair for at least five years. The lack of protein and taste of sago flour are compensated for by fish, copra and chillies. The most important feature of sago production is the absence of a particular harvest season. As a consequence, there is no hunger period nor a shortage of house construction material. This explains the absence of bridging loans or types of credit and credit relations used as food security mechanisms in the sago economy of Ambon. Also, there is no tradition of daily savings among women as there is in rice growing areas in Indonesia where women used to save a spoonful of rice each day for the difficult period preceding the harvest.

Organization of Labor

The processing of sago does not demand a large labor input. In one week a group of six persons is able to collect a three months sago supply. The construction of sago houses also does not require much labor input. With the help of relatives, neighbors, and friends, a house can be built in one day. Cooperative building of sago houses (*masohi*) takes place on demand and lacks a distinct rotation pattern and regular intervals. The paradise-like availability and durability of sago provides no reason to sustain daily labor groups and to develop highly institutionalized forms of cooperation. There are virtually no “risks of falling short of the required labor” (Platteau and Abraham 1987: 473) and, consequently, no need to develop mechanisms to ensure “ready availability of labor in times of peak operations” (Platteau and Abraham 1987: 473) because peak seasons simply do not occur. The harvest of sago palms is not seen as a question of organizing people at the right time and the right place because -- to speak in abstract terms -- scarcity of time and places is hardly felt. Strangely enough, this also applies to a large extent to traditional low-technology fishing. Although the availability of fish is insecure and subject to fluctuation, it is still considered large enough over time to meet subsistence requirements. Chauvel (1981) speaks of “little efforts that are required to meet daily needs of sago, fish and vegetables” (p.33, my translation). As a consequence, there is no need for intensification of fishing technology and labor relations, and credit which serves to tie labor has not been developed as a necessary device to organize the harvest of sago and fish.

In contrast to sago, cloves cannot be harvested every day of the year. Just before the clove trees begin to blossom, the many bundles of cloves have to be picked one by one to maintain their aromatic value. Intensive production of cloves suggests the existence of more or less sophisticated mechanisms to commit labor in peak times and/or highly institutionalized forms of cooperation among owners of clove trees. However, production of cloves is subject to large and uneven fluctuation. As a result, there is hardly any possibility to organize and sustain cooperative labor groups, in which participants help each other on a balanced reciprocal basis, to harvest their cloves. In the harvest season the labor of relatives, neighbors and friends is mobilized. The collective harvest does not so much reproduce specific labor relations, but rather more encompassing social relations between these relatives, neighbors and friends. It is exactly this family mode of collection that also characterizes the harvest of subsistence goods, like sago and fish.

Intensification and Marketing of Natural Produce

Sago and clove production do not require capital-intensive inputs pre-financed by agricultural traders. The most important tools for the sago harvest are an axe to cut down the palm and a special hatchet to cut its pith. The cultivation of cloves requires only choppers to cut brushwood between the trees from time to time. The most important tools for the harvest are ladders and baskets. Sago needs no fertilizers because of the large number of sago palms and the absence of seasonal blossoming.

The relative abundance of sago trees or -- to put it differently -- the absence of a particular harvest season, do not necessitate the use of credit to secure its marketing. Quite the opposite applies to the harvest of cloves that should take place at the right moment in the right place. However, the use of credit to secure the output of clove trees is of recent origin. It was simply not necessary during the long colonial period when rulers used force, monopoly and “slash-and-burn” policies to control the production of cloves.

The Uncaptured Paradise Under Different Political-Economic Regimes

In this section the case of rural Ambon is put in a historical perspective to yield insights into how political-institutional and economic developments have constrained or enlarged money circulation. This historical description serves several purposes: it is useful to broadly assess the significance of the agro-ecological complex under different political-economic rule and economic change. Further, it provides a necessary background to reconstruct the impact of money circulation on the evolution of forms of savings and credit. This will enable us to comprehensively deal with the question of the impact of agro-ecological conditions on these forms in the next section.

The political-economic history of Ambon can be roughly divided into four parts: the period preceding the hegemony of the Dutch East Indies Company in the Moluccas, the period of Dutch monopolistic policy for clove cultivation that began in 1656 and remained in effect till 1863, the late colonial period from 1864 till 1950, and independent Indonesian rule.

Small, Short and Insecure

With regard to the first period, Knaap (1981a) mentions that,

> The Dutch, through the Dutch East Indies Company (VOC), aimed to control the whole clove trade and for this purpose made contracts with local authorities to stipulate that the entire harvest be sold to the VOC against a price yet to be determined. [...] The price that the VOC wished to pay would turn out to be a constant source of conflict. The VOC was the first in the spice trade to pay their suppliers in cash. However, these suppliers were not prepared to pay for the rice and textile sold by the VOC because of its poor quality. The money in the hands of the Ambonese attracted Javanese and Makassar merchants and their goods to the Ambon Islands (p.27, my translation).

In spite of the contact of the Moluccan population with traders and their money, the traditional economy was not transformed into a cash economy. Knaap assumes that the trade with foreign merchants was subject to sharp fluctuations because of the irregular production of cloves. He therefore believes that the traditional economy and dependence on sago cultivation in most parts of the Ambon islands was not affected. Knaap also notes that the supply of rice to the islands was relatively insignificant in the seventeenth century. Therefore, it is unlikely that the rural population became dependent on imported rice, which might have kick-started monetization, as rice was and is not cultivated on rural Ambon. Finally, the largest share of the money ended up in the hands of local authorities: “The producer did not enjoy the largest share, because the headmen dominated the trade” (Knaap 1981a: 27). Probably, monetization did not take place on a large scale among masses of people but was stifled -- in an abstract sense -- in the exchequer of the local head.

In 1656 the clove monopoly was established by the Dutch VOC. After many years of struggle, this Company with strong military powers had definitively broken the resistance of Makassar and Portuguese traders and their coalitions with local rulers. The VOC forced the population to sell cloves to the Company only. In return, the Company offered to buy all cloves at a fixed price. During the seventeenth century this price was set at 56 rixdollars per bahar (550 pounds): five for the local rulers, one for transport and 50 for the producer (Knaap 1981b). This meant that the producer should be paid about 45 cents per kg of cloves. The farmgate price remained about the same during the whole seventeenth and eighteenth century and was, for instance, 48 cents per kg in 1824 (Knaap 1981b: 18). To get an idea of the exchange value of cloves and rice at that time, the following figures are illustrative: in 1824 50 clove trees, together yielding 500 kg of cloves, would buy more than four tons of rice that, in turn, might feed 20 people for one year[2]. The annual import of rice in Ambon was not more than five to seven hundred tons, to feed not more than 3,500 people for one year.

In principle, a lot of money could be earned by owners of clove trees from the sale of their produce. However, it is not clear whether the prescribed price of 50 rixdollars was actually paid to the producers and how much income was extracted as a result of unfair weighing practices (cf. Knaap 1981b). Also, the clove production policy of the VOC was responsible for a fluctuating and uncertain income for producers: the VOC ordered the planting of clove trees when prices were high and their burning when prices were low. Because of a time lag of about five years between the planting and maturity, this drastic policy was an inappropriate response to international price developments. This policy only aggravated the uncertainties of irregular clove production, reinforced the subsistence orientation of the rural population, and confirmed sago instead of rice as the standard staple. The circulation of Dutch guilders, cloves and rice was simply too small, too concentrated with a few people, and too irregular to replace fishing and the collection of sago as the bases of rural life.

In 1863 the VOC was forced to abolish its clove policy because international market prices had sharply decreased, as a result of the expansion of clove areas outside Indonesia. One of the consequences was that the rural population no longer faced the insecurity related to the “slash-and-burn” policy of the VOC but, instead, new insecurity as a result of the strong fluctuation of prices of spices. Spices could not provide a stable economic basis. Basic life needs were easily met in Ambon, and spices were sold only to meet “small money needs” (Chauvel 1981: 35). The basis of the economy remained unchanged. “At the end of the colonial era, no one had found the key to escaping the pattern of sago, fish and coconut” (Chauvel 1981: 35, my translation).

The change of political leadership as a result of independence did not turn the subsistence economy of Ambon upside down. Until 1965 Ambon was rather the stage for political turmoil and guerilla war. Ambonese emigrants, who had enjoyed higher education in the Netherlands, declared the South Moluccan Republic (RMS) shortly after returning to Ambon, causing military intervention by the national government. According to Fraassen (1981: 31) the RMS was “an economic disaster”. The political turmoil did not stimulate the national government to invest in peripheral Ambon, while conflicting views among Ambonese people about a Moluccan republic were a further impediment for regional economic growth. Again, the significance of sago and fish as subsistence crops and their profound effects on rural life were not reduced, but rather reinforced.

The Increase in Money Circulation

During the last 25 years a number of mutually dependent changes occurred that are directly related to the circulation of money, financial needs and access to financial means. These changes strongly affected the subsistence economy of rural Ambon, which for centuries had remained a basically unchanged and uncaptured paradise, in spite of early exposure to international commodity markets. In the first place, money now circulates faster and among many more people than 25 years ago. Possibilities to earn money from farm and off-farm activities have greatly improved, due to both an increase in the area of cash crops and an expansion of government staff and the number of commercial enterprises. Sharply increased prices of cloves have resulted in enormous cash flows into village economies. Up to the 1960s (cf. Fraassen 1972) cloves yielded prices equal to only a few 10-cent pieces per kg. However, in the seventies the price of cloves soared, until 1 kg yielded 30 Dutch guilders in 1976 (Fraassen 1981), or about 100 times the pre-war price. Secondly, the supply of money to villagers by (semi-)government credit institutions has increased enormously. In the seventies the People’s Bank of Indonesia (BRI) launched a credit program for the intensification of clove production (KIC), and in the eighties a program (KUPEDES) of special credit facilities for small entrepreneurs and government employees. Thirdly, the demand for money has increased, too: for daily consumption, housing, school expenditures and the pilgrimage to Mecca. The restrictive codes on consumption behavior that, for instance, once allowed only

2. The table of Taale (1988: 182) with annual prices of rice in the period 1744 to 1863, shows that 100 kg of rice in Ambon cost 5.77 Dutch guilders in 1824. In 1744 the price was 4.05 guilders, whereas in the first half of the eighteenth century the price varied between 3.19 and 10.61 guilders.

village heads to wear shoes, have faded (Fraassen 1981). Access to schools is no longer a privilege of a tiny elite.

One cannot underestimate the significance of changes in the consumption standards of rural Ambon. The use of sago trees for housing and food, in fact, maintained the agrarian relations and forms of cooperation of a subsistence economy, and did not involve money transactions. Now that rice and concrete houses have become the new consumption standards of most Ambonese, the key to escaping the pattern of sago, fish and coconut -- to speak in Chauvel's terms -- has been found. It is in the minds of the people themselves who are much more concerned with earning and spending money than was possible in the colonial era. Rice consumption necessitates small daily cash flows. The construction of a concrete house requires a huge amount of money, equal to the proceeds of a good clove harvest.

Large-scale and regular money flows in and through rural communities are part of monetization and commoditization processes that can hardly be compared with the colonial era, when rural money flows were relatively small, short and insecure. Because of the central role of sago for traditional food supply and housing, the change of consumption preferences has had a dramatic impact on rural life. New consumption standards and related money needs have implied the erosion of traditional Ambonese patterns of cooperative food collection and house construction. Parallel to this break-down of traditional agrarian relations, new types of relationships and forms of cooperation between villagers have emerged, that include new and different forms of savings and credit (cf. Hospes 1992a, 1992b).

Changing Positions in the Market of Money and Trees

The general processes of monetization and commoditization did not affect all rural Ambonese in the same way, but went hand in hand with more social-economic differentiation among villages and villagers. The position of a village in regional trade networks proved an important factor in this respect. At intra-village level, the different positions of villagers in terms of rights to land and trees explained and reinforced the differentiating impact of the increase of money circulation.

One of those places in rural Ambon where money circulation has extraordinarily increased and has much affected intra-village relationships is Tulehu. In this section, I will concentrate on changing social and economic relations between Butonese migrants and their Ambonese hosts, and their credit relations in particular. In Tulehu these migrants have become important as traders and credit suppliers in the market of cloves and nutmeg. My purpose is to analyze how the combination of economic change, different rights on land and trees, and location-specific cropping patterns have affected Ambonese-Butonese relations, including their credit arrangements.

A Place Where Money Grows

The village of Tulehu is situated on the Northeastern coast of Ambon island. It has evolved in the last 20 years as a regional transport and trade center, linking the city of Ambon and the hinterland of the Central Moluccas. It attracts many people who want to earn an income or enroll in classes at one of the many schools. Local officials even say that Tulehu now belongs to the urban society. This would have been an unrealistic statement 20 years ago when Tulehu did not differ much from other villages. Students describe the local economy as a cash economy where money has to be paid for school fees, breakfast snacks and transportation. Farmers have their own way to describe complex processes of commoditization and monetization: "*biar daun kasbi, bawa ke pasar, jadi uang*" (even casbee leaves turn into money when you bring them to the market). Adults complain that young boys now demand payment in cash for plucking their coconut trees.

Nowadays, even those families who are still primarily involved in sago cultivation and subsistence fishing, spend at least Rp.3,000 (or US$1.70 in 1989) per day to buy rice, some vegetables, a few cigarettes, pay school fees and -- if necessary -- buy fish. Fortunately, Tulehu offers many opportunities to earn money: street vending, bus driving, fish trading, boat driving, vegetable selling, and loading and unloading busses and boats. The villagers speak of "*cari uang*", which literally means searching money, as if the money is already there but only has to be found, like the many sago and fruit trees that have only to be located and harvested.

Invisible Hands

Kennedy (1950: 25) described Tulehu as "the biggest negeri population in Ambon" of about four thousand people. According to the local government, Tulehu had nearly 12,000 inhabitants in 1990 and is the largest village of Ambon. Villagers agree that Tulehu has become densely populated. The actual number might even be a few thousand higher because it is rather doubtful that all Butonese migrants are included in the official count.

Upon their arrival on Ambon, Butonese migrants settled at the fringes of the villages and became subsistence farmers and fishermen like many of their Ambonese hosts. The paradise-like Ambon islands have been a popular destination of many Butonese, who have migrated from the rocky and barren areas of Southeast Sulawesi since the end of the last century. Today, they form about one third of the rural population. Many of the Butonese migrants are now entrepreneurs who dominate non-mechanized and mechanized sago processing, as well as fishing and the clove trade.

Migrants, such as the Butonese, have no local-traditional land use rights: they are not allowed to cultivate perennial crops, like cloves and nutmeg, or to build concrete houses on land owned by Ambonese clans. According to customary law, such actions would imply more or less irreversible ownership rights on the land. Therefore, many Butonese typically live in simple wooden houses and cultivate annual crops, like tuberous plants and vegetables.

The particular role of Butonese in clove production and trade on rural Ambon is very much dependent on location-specific relationships with the Ambonese. A major determinant of the nature and change of these relationships has been the enormous increase in the circulation of money. In Tulehu this increase has led to disintegration of agrarian relations and of cooperation among the Ambonese. Parallel to this development, the Ambonese and Butonese seem to have become closer in a two-fold sense. First, the economic position of many Butonese has improved vis-a-vis Ambonese in terms of investment capacities, bargaining power and ownership rights. The growing importance of Butonese tenants and traders as moneylenders has reduced the “distance” between the privileged and powerful Ambonese land owners and the landless, submissive Butonese migrants. Butonese and Ambonese have also become closer in a spatial sense. Whereas the early settlers were allowed to build small and simple houses only in the hills, current generations of Butonese migrants encroach on the Ambonese center of the village. Many of them build concrete houses that match Ambonese standards.

The enormous increase of money circulation and money needs on Ambon has affected the social-economic life of the Butonese in many ways. First, the typical subsistence production of the Butonese has obtained an extra dimension. It is no longer a survival strategy only: the Butonese, through frugal living, succeeded in saving much money. My cashflow research among Butonese and Ambonese indicates that average daily expenses of Butonese are structurally lower than those of Ambonese.

Further, social-economic differentiation has taken place among the Butonese themselves. Most of the migrants started on Ambon as subsistence farmers and fishermen; now the Butonese have developed other agro-economic activities as well. Some, especially those who live close to small rivers and large sago forests, have recently specialized in mechanized sago processing. Others have built large wooden fishing rafts (*bagan*) or have become important clove traders. Although there still is a large class of survival-oriented farmers and fishermen, it would be wrong to consider the Butonese as a homogeneous class of people in terms of agro-economic activities. In every *kampong* the Butonese have exploited the particular opportunities of nearby natural resources, roads and rivers.

The role of the Butonese in clove production and marketing has drastically altered. Whereas in earlier times they only helped to process cloves (*bantu petik*) in the gardens, they are now the largest category of itinerant buyers of cloves and credit suppliers of rural Ambon. According to the chairman of the village cooperative of Tulehu that is officially in charge of the purchase of cloves from the farmers since 1980, the need of Ambonese to sell the usufructuary rights of their clove trees, arose in the seventies when periods between bumper harvests increased. The increase of money needs as a result of new housing and food standards only reinforced this need. The Butonese met this demand and quickly became popular tenants-cum-creditors. Their activities soon began to yield financial benefits. In 1974 the Butonese migrants bought the first pieces of land to build concrete houses and so consolidate ownership rights. The Butonese also started at that time to fish with the quite expensive wooden rafts (*bagan*). Both the concrete houses and the wooden rafts can be seen as turning points in the economic position and activities of the Butonese migrants of Tulehu.

Finance and Risk-Minimizing Strategies of Butonese Clove Traders

Butonese traders employ various strategies to buy cloves from Ambonese owners of clove trees. In the Indonesian language they are called *beli cupa, panjar uang, beli buah* and *sewa pohon*.

Beli cupa literally means “to buy a tin”, and refers to the purchase of fresh cloves using an old tin of condensed milk as the standard unit. After the purchase, the Butonese dry the cloves in the sun: 12 to 14 tins of fresh cloves yield about 6 to 7 tins of dried cloves, or 1 kg. As the drying process only takes one or two days, the buyers hardly bear the risk of a fall of prices. The profit margins are usually small, but keen entrepreneurs can make a handsome profit. In general, Butonese women seem to be the primary buyers of cloves. They live close to the clove gardens and can simply wait for the Ambonese farmers to come down from their gardens to the village. They also move in small groups to those gardens where a harvest takes place. There are distinct advantages in selling the freshly picked cloves right away to the Butonese women. After a hard day’s work it is very satisfying to cash your cloves immediately and not to worry about the drying. Also, money is easier to hide from greedy relatives than some buckets of cloves.

Panjar uang means "to advance money". According to La Macid, who is reputed to be the largest Butonese clove trader of Tulehu, *panjar uang* is similar to *cengkeh kilo,* which means a kilogram of cloves. It refers to a relatively low fictive price of cloves, used to calculate the amount of cloves needed to repay the advance at a future date. In rather isolated villages on the large island of Ceram, small shopkeepers supply advances based on a similar agreement. However, it is not money that is supplied in advance, but consumer goods.

Beli buah means "to buy the fruit". It refers to a pre-harvest arrangement in which the right to harvest a tree is bought when or after the very first signs of the inflorescence of a clove tree are visible. These signs, very small and light-green leaves, are visible about seven to eight months before the harvest and show which trees might produce well.

Sewa pohon is also a pre-harvest arrangement, and means "to lease a tree" through buying the usufructuary rights of one or more good seasons. Another main difference with *beli buah* is that *sewa pohon* implies the purchase of one or more good harvest seasons. In fact, the lessee provides a medium- to long-term credit to the owner of the clove trees. The arrangement implies that the creditor does not have to accept a poor harvest as repayment of the loan, only a good season counts. In case of not easily definable harvests, the lessee and owner usually agree to share the yield on an equal basis. Both parties might also agree to define a poor or moderate harvest as repayment of a "half season". These rules and decisions are ways to deal with the risks related to the fluctuating and unpredictable production of cloves.

There are some other interesting differences between *sewa pohon* and *beli buah*. They all refer to an inverse relation between risk and profit-making in the clove trade. According to La Batini, a very knowledgeable and respected Butonese farmer, the following rule of thumb applies to *beli buah*. A tree that will probably yield about 10 kg of cloves should be bought for the price of 8 to 9 kg; in case of *sewa pohon* one does not pay more than the price of 3 to 4 kg. Other Butonese farmers suggest that the price of a *sewa* contract should not exceed half the expected yield, to cover all the costs (maintenance of the clove garden and hire of harvest laborers) and make a small profit. One explained that "we have already won" at a price of one million rupiah to lease 50 trees with an average yield of 7 kg per tree and a current market price of Rp.7,000 per kg. In comparison to *beli buah*, *sewa pohon* represents a much larger price and yield risk, but also the promise of a larger profit. The risks of *sewa pohon*, however, are differently assessed by Butonese farmers. La Batini, for instance, describes *sewa pohon* as to save in a tree. According to him, one cannot make a loss with *sewa* contracts. It is very striking that La Batini calculates in absolute terms and not on a time basis (cf. Shipton 1992).

Butonese traders seem very aware of the uncertainties and risks in clove production. The location-specific and evolving credit or credit-like arrangements with the Ambonese tree owners, mirror these uncertainties and risks, making them resort to additional adaptations in strategies. The working area of Butonese clove traders is not necessarily restricted to their own neighborhood. Just before and during the harvest period they can be found at places where bumper harvests are expected, and making long term pre-harvest arrangements with owners living in another village or even sub-district. Some Butonese migrants have become much more reluctant to make long term pre-harvest agreements after clove prices started to fall dramatically in the second half of the eighties. Others emphasize that such a development only requires an adjustment of the price in a new agreement.

Lessons and a Look for "Localization"

Agro-ecological conditions and economic change in rural Ambon have not only affected the historical development of Butonese migrants and their lending strategies in particular, but those of other marketing agencies and financial intermediaries as well, like village cooperatives and rural banks. In this final section I will describe quasi-official adjustments and informal practices of bankers and cooperative chairmen, who have realized that the implementation of the official standard programs is not possible. In my view, disregard of the specific agro-ecological conditions explains much of their problems. National planners ignore these specific conditions, and so frustrate the rural bankers and cooperative chairmen, who are supposed to finance the clove production and buy cloves directly from farmer members. I believe that a closer look at agro-ecological conditions might produce useful insights to make location- or region-specific credit programs and so save a lot of money.

However, it should be emphasized that this brief analysis is not another attempt to extract a financial technology that guarantees the success of rural banks or cooperatives as official suppliers of financial services. Their success, defined in terms of either internal sustainability or delivery of financial services to rural poor, depends not only on agro-ecological conditions, but also, for instance, on political-administrative and economic environments. I also do not want to suggest that official suppliers of financial services are the sole agents of change of financial landscapes, and would only need the proper technology to bring prosperity to the poor. One should have few expectations of the effect and use of “appropriate” financial technologies in official policies and programs. Adams’s 20 years of experience with problems in rural financial markets taught him that the attempts to establish sustainable agricultural credit programs in the past two decades have largely failed “despite the tens of billions of dollars committed to hundreds of these efforts” (Adams 1992: 5). He also found that these generous financial commitments sharply contrast with the piecemeal use of new insights in rural financial markets.

Lessons

Since 1980, village cooperatives (KUDs) have the official mandate to buy cloves directly from the farmers for a fixed price. The province of Ambon belongs to the six provinces officially classified as clove producing areas in 1980. During the last decade this number has grown to 14. Several agencies are supposed to provide supportive services to the KUDs, such as control of the quality and the marketing of cloves at district level, horticultural extension and the supply of working capital. The Bank Rakyat Indonesia (BRI) is responsible for supplying financial services. Just before the harvest season, the BRI lends the so-called Kredit Tata Niaga Cengkeh (TNC) to individual cooperatives, to be repaid at the latest three months after the harvest season that ends in January.

In the first half of the eighties, cooperatives borrowed enormous amounts of money, that is, 90 to 120 million rupiah or US$50,000 to 70,000 per cooperative. However, many cooperatives were unable to buy the equivalent in cloves and to wield their monopoly powers in the clove market. The first cooperative managers, who were only familiar with village shopkeeping -- if at all -- lacked the management capacities to run a million enterprise. Private traders were much better equipped and/or better informed. In addition, many traders offered credit as part of a pre-harvest arrangement. As a result, cooperatives were unable to increase their market share to more than a few percent (cf. Godoy and Bennett 1990). Last but not least, there were simply not enough cloves to buy in the own village area of the cooperative during the slack seasons between bumper harvests. To sum up, the BRI had overestimated the entrepreneurial capacities of cooperative officials and had been unaware of, or at least had underestimated, risks related to marketing of cloves as a result of its irregular production. In addition, embezzlement of excessive credit took place on a large scale. The result was that many cooperatives got heavily indebted.

The directors of the BRI of Ambon have lost faith in the cooperatives, and have adjusted their lending strategies accordingly. New credit applications from heavily indebted cooperatives are now simply refused. According to cooperative officials, more than one third of the 72 registered cooperatives of the Central Moluccas belonged to this category in 1990. Next, the volume of the Kredit TNC has been reduced to 8 to 12 million rupiah per cooperative. More importantly, the BRI has put more faith and finance in urban shopkeepers and wholesalers involved in clove marketing.

The failure of the direct financing of clove farmers by the BRI has led to a similar response. The program Kredit Intensifikasi Cengkeh (KIC), meant to increase clove production in Indonesia, started in Ambon in 1975. The BRI supplied credit to smallholders[3] in cash and kind with the help of the horticultural department. A farmer borrowed a standard amount of money and fertilizer per tree to be repaid after the harvest. However, the use of fertilizer did not lead to an increase in production and, more importantly, did not end the irregular production. As a result, repayment records were embarrassingly poor. The decision in 1980 to make KUDs responsible for the collection of cloves and the repayment of loans also did not work out very well and, in the end, the program was stopped in 1983. The “target group” that has proved most attractive to the BRI are private traders, that is, professional traders and shopkeepers who are typically part of family businesses, or family-like trade networks that combine urban and rural areas.

The village cooperatives, that is, the chairmen and their assistants, have also been much more inclined to develop sound working relations with private traders than with farmer members living in their own village. The opportunities for cooperative officials to develop stable working relations with farmers are very much restricted, due to the irregular production of cloves and its very labor-extensive cultivation outside the harvest season. The working area of private traders is not restricted or bound to a village area. As a result, traders are much more able to secure the supply of cloves than are cooperatives. Wholesalers sell their cloves at the central cooperative (PUSKUD) via the KUDs, at times when market prices are much lower than the standard price offered by the PUSKUD. Some cooperatives even place their Kredit TNC at the disposal of these wholesalers. Other cooperatives imitate the strategies of private traders and have started to operate in a larger area, contacting farmers of other villages and buying their cloves well in advance.

3. According to Godoy and Bennett (1990) in 1983, “The area under cloves was less than one hectare for 96 percent of all Indonesian clove smallholders, and for 95 percent of clove smallholders in Maluku. The average number of trees per household was 62 nationally, and 76 for Maluku” (p. 66).

To Look for "Localization"

A closer look at specific agro-ecological conditions is not to produce generalizations that might be useful to policymakers calling for formulas that cut across countries. Many generalizations do not take into account location-specific variations in the political-administrative, socio-legal, economic and agro-ecological conditions that affect financial decisions of individuals and institutions. Therefore, I expect that the 20-years-old litany on the failures of governments to establish sustainable credit programs to the benefit of rural poor, will be heard for the next 20 years as well. To draw generalizations from case studies of financial intermediaries as a way out of these failures, will at best lead to substitution of formulas, but will not stimulate a better analysis and understanding of location-specific situations and problems. Therefore, I believe that what is needed in policymaking and research is not the pursuit of generalization but the pursuit of "localization".

With regard to policymaking, "localization" implies that national plans are adjusted to regional or local conditions, including agro-ecological conditions. "Localization" also suggests decentralization of planning, down to lower levels of administration, such as provincial and district levels. If there is to be an interest among researchers in studying agro-ecological conditions, with the specific aim of drawing lessons for policymaking on rural financial intermediation, this study should include the analysis of processes of policymaking and its political-administrative constraints. It is quite embarrassing to find that policy-oriented research has hardly given any attention to these processes of and barriers to policymaking.

From an analytical point of view, I feel that the pursuit of "localization" fits perfectly in the broad concept of rural finance outlined by Schmidt and Kropp (1987). Such a pursuit would question how agro-ecological conditions affect the financial decisions of individuals and institutions in a particular area or "locality". It also raises the question how (changing) economic, political-administrative and socio-legal conditions affect these decisions, and at the same time weaken, reinforce, transform or differentiate the impact of agro-ecological conditions.

The case of Ambon provides its own and specific answers to this two-fold agrarian question of financial landscapes: the particular combination of sago and clove cultivation has implied labor and loan arrangements that greatly differ from similar arrangements in rice producing areas (cf. Ghate 1992: 43-57) and also, other silvicultures, like rubber and coconut. Cloves are a pure cash crop and have a production cycle in which bumper harvests occur every three to four years, with insignificant yields in between. In addition, large variations in production can occur in a small area. As a result, highly institutionalized forms of cooperation among owners of clove trees, and the use of credit as a labor-tying device, have not been feasible. The processing of sago does not demand a large labor input and provides a minimal basis in terms of food security and housing. Furthermore, there is no particular sago harvest season. As a result, types of credit and credit relations that either guarantee food security or ensure ready availability of labor, have been absent in the sago economy of Ambon. The non-mechanized collection of sago as well as the harvest of cloves by Ambonese required rather ad-hoc forms of cooperation, reproducing broader social relations between relatives, neighbors and friends.

The cultivation and consumption of sago have structured rural life on Ambon for centuries, and have proved very important in times of hardship. Under different colonial regimes, the subsistence role of sago, in combination with fish and coconut, was not weakened, but rather reinforced. Rigid clove-production policies caused relatively small, short and insecure income flows that could not provide a stable economic basis. In the post-colonial period, however, the subsistence-oriented economy was turned upside down. As a result of the dramatic increase in the money circulation and changes of consumption standards during the last two decades, the subsistence role of sago weakened. The sharp increase of clove prices in the seventies provided a major impulse in this connection. Concrete houses and rice became the new consumption standards. Consequently, traditional forms of cooperative food collection and house construction among Ambonese eroded. Parallel to this development, new types of relationships and forms of cooperation emerged, including credit relations between Ambonese and Butonese. Butonese migrants quickly responded to the increase of money needs of Ambonese and supplied credit in exchange for the right to harvest their clove trees. In this connection, these trader-cum-moneylenders have done much better than official cooperatives, who have failed to gain a large share in the marketing of cloves. This is largely due to the diverse financial and risk-minimizing strategies of Butonese, who have developed much better insights into location specific agro-ecological conditions than have cooperative officials.

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15

Mapping and Manipulation of Traders in Sri Lanka

Sarah Southwold-Llewellyn

Much of the debate on financial intermediaries has focused on the institutional aspects of the formal sector. For example, the debate on why Specialized Farm Credit Institutions (SFCIs) have failed has focused on administrative problems. Some of the reasons for these failures can be understood by comparing how SFCIs function in comparison with informal sector intermediaries, such as traders (Southwold-Llewellyn 1987, 1991). And indeed, a number of recent policy interventions to stimulate the provision of credit have tried to institutionalize features of informal sector finance found in ROSCAs and in credit from traders (Adams and Fitchett 1992). A major flaw in an institutional approach, as in much of policy intervention and social engineering in general, is the assumption that there is a simple cause-effect relationship between a limited set of variables. It seems to follow from this that, if one variable is changed, there will be a predictable change in the others.

The purpose of this chapter is to explore some of the multiple contextual frameworks of financial intermediaries in Sri Lanka, within the specific context of a set of government interventions during the early 1970s. These will help to explain the changing credit relations of borrowers and lenders in a small rural commercial center. The exploration of these specific multiple contextual frameworks will throw light on the range of issues that should be taken into account if effective credit interventions are to be implemented.

The Context of Location

The focus of this case study is Polgama (a pseudonym), a village 10 kilometers north of Kurunegala, Sri Lanka, where fieldwork was done for 15 months during 1974-1975. Additional material was collected in nine surrounding villages. Polgama and its adjacent village of Gonnawa (pseudonym) form a center for commerce and services in the vicinity. Visually, they are one center; and are thus referred to as Polgama-Gonnawa. There was a sub-post office, a railway station, two bus services to Kurunegala, a secondary school, a government dispensary plus an Ayurvedic physician and his dispensary, two cooperative stores, a rural bank, a weekly periodic market, and 66 shops of which 42 were shops of traders. Since World War II people have immigrated to this area increasingly, because of the good facilities and relatively cheap land. Consequently, Polgama-Gonnawa has become the main trading area for the agriculturally based interior villages.

Although this area lies just outside the "Coconut Triangle", ecologically it is plainly part of the area. Coconut visibly dominates the landscape. Mature palms grow everywhere except on the land reserved for paddy cultivation. In the villages, houses and other buildings are built amidst the palms.

The Context of the Policy Discourse Against Traders

A major strategy for development in the 1960s and 1970s was founded on the assumption that the state should intervene to replace the private trader. "One particularly prominent strand in Western discourse, which goes back to Aristotle, is the general condemnation of money and trade in the light of an ideal of household self-sufficiency and production for use... Profit-oriented exchange is, however, unnatural; and is destructive of the bonds between households" (Bloch and Parry 1989: 2). Neo-Marxist analysis of traders as a mercantile class, whose actions promote underdevelopment, was a contemporary illustration of the influence of this idealized morality.

> Four striking features of this analysis of the role of commerce in under-development are the high level of theoretical abstraction in which it is couched, the use of macro economic indicators for empirical "verification", the pointed neglect of the work of (presumably bourgeois) anthropologists, and the conceptualization of traders as "unproductive". This latter carries with it the strong implications that traders are not necessary and moreover, that state intervention to replace rather than to regulate private trade will lead to more productive uses for resources extracted by agriculture (Harriss 1981: 13).

More recently Barbara Harriss (1989: 169) has noted that "...There is no necessary connection between commercialization and agricultural growth or between merchants' capital and class formation. The connections need empirical specification". Schaefer-Kehnert and Von Pischke (1986: 8) also point to the lack of empirical evidence to support the thesis that traders (and moneylenders and landlords) make monopoly profits and use the debt relationship to exploit their clients:

> Nor is there any general theory to explain why some small farmers in certain countries, cultures, or production situations live perpetually in debt. It is generally assumed that they have no other choice, but there is not much evidence, say in the form of liquidity studies, that would support this assumption (1986: 8).

The intellectual bias against traders was adopted by the colonial administrators in South Asia and, in turn, implemented in their policies aimed at curbing the role of traders in the economy. This discourse can be seen as a context which influenced policies of successive Sri Lankan Governments before 1977. From 1971 to 1977 the United Front were in government. The Sri Lankan Freedom Party was the major party in the coalition which also included two communist parties: the Lanka Sama Samaja Pakshya (Trotskyist) and the Communist Party (Moscow). This was a quasi-socialist government which held the view that traders are agents of underdevelopment; but similar views were held by preceding governments. A major strategy for development has been founded on the assumption that state intervention to replace the private trader would lead to a more productive use of resources. The approach of successive Sri Lankan governments is illustrative. "...Irrespective of the party in power, the governments had looked to the elimination of the *mudalali* (trader) as the major goal of their rural economic policies" (Alexander 1981: 122). "The cooperative movement was started in Ceylon in order to furnish the peasant some relief from the monopolistic lender, buyer, and supplier" (Tambiah 1963: 90). Two major approaches to by-pass dependence on traders were adopted. One was the establishment of institutional credit schemes for agricultural production at relatively low rates of interest. The second was the introduction of alternative marketing infrastructures which would give producers a better price and free them from indebtedness. In Sri Lanka, these schemes were aimed, predominantly, at paddy; but there were also less comprehensive attempts aimed at dry grains, vegetables, and coconut.

Prior to 1971, paddy and rationed rice were important sources of collateral for credit for groceries from shopkeepers. Coconut was also important. It was used as collateral for goods from shopkeepers, as well as for cash from traders specializing in coconut sales and copra production. Typically during this period, the most affluent traders had businesses which combined grocery shops with trade in paddy and coconut. During fieldwork in 1974-75, coconut had become the major collateral for credit, and the major source of credit for consumption was the specialized coconut and copra merchants who advanced cash for a future harvest.

The relative importance of shopkeepers and the use of paddy as collateral had declined. In 1974-75, the grocery shops had few goods to sell. The most affluent traders were those who concentrated solely on coconut. The apparent reason for this was a change in legislation. In 1971, the United Front Government prohibited the sale of paddy, except through the Paddy Marketing Board. Ostensibly, this legislation had a dramatic effect on the use of paddy as collateral. Most shopkeepers complained that this had had a devastating effect on their businesses and that this was a major reason why they could not afford to extend credit to customers as they once had done.

This illustrates the impact of a single intervention on changing credit relations. However, it does not explain the situation fully. For example, paddy continued to be marketed on the black market by shopkeepers elsewhere. And indeed, trading of rationed rice and other rationed goods was not curtailed despite earlier legislation in 1956, which made it illegal to sell or transport rationed rice. Similarly, coconut continued to be sold by local traders in spite of the numerous alternative marketing channels which were set up by the government. Nor does the government's legislation on paddy marketing explain the continued decline in the number of loans taken out through formal sector agricultural production schemes. Nor does it explain the decline in capacity for savings as individuals or in groups, such as ROSCAs or burial societies. More fundamentally, it does not explain the changing content of credit relations between traders and between traders and their customers. To do this requires looking at additional contexts and the credit strategies of individual actors.

Agro-Ecological Context

In the research area there are two main agricultural crops: paddy and coconut. Ideologically (Southwold-Llewellyn 1994) and nutritionally, paddy is more important.

Paddy

There are two major planting and harvesting seasons. *Maha* is the major cultivation season, roughly from September to March, although in Polgama it is conventionally taken as starting in October. *Yala* is the minor cultivation season from April to August, when the rainfall is less in quantity and reliability.

Polgama is in the Intermediate Zone, which is the area between the Wet Zone where no irrigation is required for paddy cultivation and the Dry Zone where irrigation is essential for two harvests a year. There was no canal irrigation in the area. Most villages did have reservoir irrigation, although this was insufficient during the two planting seasons studied, except for fields nearest the reservoir. A few farmers irrigated from wells. In Polgama, there was no irrigation of any kind.

This marginality of paddy cultivation was exacerbated by a drought which had started five years previously. According to the Agricultural Extension Officer, the Polgama water problem was not new. From 1963 to 1969, Polgama had three-quarters of the harvests that other villages in the vicinity did; but from 1969 to 1975, there had not been enough rain for successful cultivation. This is certainly supported by the household survey of Polgama from which the harvests starting from *Maha*, 1971, were recorded. Depending on the location of the plots and the cultivation techniques employed, the harvests of the previous five years had varied; but they had been very poor generally since *Maha*, 1969-70. During *Yala*, 1975 (April-August), there was no attempt to plant paddy in any field in Polgama.

Consequently, there had been a decreasing commitment to paddy cultivation. Hence, the adoption of the HYV package of “new” techniques for paddy cultivation was cautious. Ironically, Polgama was one of the most productive paddy cultivating villages in the whole of Kurunegala District in 1938, producing yields between 25 and 30 bushels per acre (Shenoy 1940: 12). Although one must be cautious in interpreting agricultural statistics, these yields correspond, roughly, to those reported for years preceding the research. In other words, the yields are only poor in comparison to those to be expected when using HYV technology. Yet, even during this earlier period, coconut, as a cash crop, was a more important source of income than paddy.

Within this context, it is not surprising that traders were reluctant to extend credit for a future paddy crop which had a high probability of failure.

Coconut

In contrast to paddy, coconut was a reliable and predictable crop to which every household had some access. Firstly, coconut was harvested every two months, rather than once or twice a year. Secondly, there was always a harvest. Although the volume and price might vary, it was normally predictable in advance.

The volume of the crop varied with an annual seasonal cycle which peaked during May and June. The high season was usually between April and July; the low season was between October and January. Two prominent features of farm gate prices were that there were wide price fluctuations between years and that price fluctuations between months tended to be much wider than yearly fluctuations (Sri Lanka Government 1984: 19). The national price fluctuations reflected variation in production. To a lesser extent prices were also affected by government price policies aimed to benefit urban consumers and by the international market (see below). These fluctuations were predictable for both producers and traders. The drought also affected coconut production; but during the year of study, there was a glut of coconut relative to other years. The consequence was that, while the average price of a coconut for small producers was 36 cents in 1974, in 1975 it had dropped to 17 cents. In other words, although coconut production increased, the actual total income for producers was less than it had been in previous years.

In spite of the fluctuation in income from coconut due to variations in productivity and market prices, the producer could be assured of some income. A coconut palm will continue to produce nuts for 70 years without any input costs and in conditions of drought, although productivity will be adversely affected. In contrast, there can be no garden cultivation, intercropping, or paddy cultivation without a reliable source of water and cultivation inputs.

Almost every household had access to coconuts for consumption, sale and/or barter. High land (or dry land) is a general term for all permanently cultivated land, other than paddy land (wet land). Most high land had coconut planted on it. In contrast to paddy land, 57 percent (40) of the households in the Polgama household survey owned some high land, while only 37 percent (26) owned some paddy land. But the most significant difference in the distribution of these two types of land was that everyone, whether he owned land or not, had access to some high land. With one exception, every landowner who had a tenant living on his land, regardless of whether or not rent was paid or the tenant was a watchman on his estate, would permit the tenant to pluck coconuts for his household’s own consumption, and to cultivate fruit and vegetables.

Because coconut was the only reliable crop, it was the major source of collateral for credit. Most households were involved in credit transactions which involved coconut at some level. Coconut had become a rural currency. Hence there was increasing dependence on traders who marketed coconut, especially the specialized coconut and copra merchants. Yet neither the legislation on the restriction of paddy marketing nor the agro-ecological context explains the declining role of shopkeepers, especially those predominantly selling groceries, in extending credit.

Wider Economic Context

In 1975, there was a general decline in agricultural incomes, both from paddy, due to the drought, and from coconut, due to the glut in production. However, the agro-ecological context should be placed in a wider economic context. The occupational structure of Polgama was not limited to agricultural sources of income; nor was the location of occupation demarcated by the vicinity. In addition, international market prices for coconut and other commodities had an impact on local prices, as did the government's policies which were a response to the international market, as well as to other factors.

Occupational Structure

The bulk of coconut and paddy supplies for the market was produced by households whose surplus was small or marginal. Most government schemes, especially those for agricultural credit, however, seemed to be geared to an ideal household producing sufficient surplus for agriculture to be the primary source of income. The myth of the peasant cultivator over-emphasizes the role of agriculture in income and influences the ways national and international policy makers conceptualize "the peasantry" and identify their needs (Southwold-Llewellyn 1987, 1994).

Although agricultural produce, particularly coconut, made some contribution to most household incomes, farming was the primary source of income for only 10 out of 70 households surveyed (14 percent) in Polgama. Forty-six percent (32) of those surveyed said that farming was a source of cash income. In addition, although few households attempted to grow a substantial part of their consumption needs, most grew some vegetables and fruit. However, given the limited amount of land, cultivation was not the primary source of income for the community since the majority did not have access to enough land to meet their subsistence and cash requirements. Even in those households where farming was the largest source of income, in each case the household income was supplemented by other sources.

As a consequence of the supplementary, rather than primary contribution of agricultural production to the economy, economic diversification was a pronounced feature of Polgama. This diversification took two forms: the diversity of occupations and the multiple sources of household income contributed by different household members. Roughly one third were in skilled (e.g. clerks and teachers) or skilled craftsmen's occupations. Another pronounced feature was the location of employment. Thirty-one percent of those employed worked outside the vicinity (more than six kilometers away). Fourteen percent of those employed worked in towns.

Trading was another main activity that households used to supplement their agricultural income. There was a proliferation of small-scale trading businesses which can be explained by the inexpensive prerequisites for trading and by the central location of Polgama. Without exception, all the traders in Polgama-Gonnawa started trading with a small investment of goods or agricultural produce of the value of Rs.25 to Rs.200. (In 1975, the official rate of exchange was Rs.15.3 to £1). Entry into trading at this level was virtually unrestricted. In the category of trader is included teashop-keepers, grocery shopkeepers, coconut and copra merchants, as well as peddlers and market vendors. These sub-categories are simply a heuristic device: most traders have businesses which fit several of these sub-categories at any one time, and their types of business have changed over their career histories. One third of households had a member who was, or had been, engaged in trading. Seen from this perspective, the attempt to view traders as a separate social category should be questioned both theoretically and methodologically, and certainly with regard to its policy implications (Southwold-Llewellyn 1994).

These figures do not reflect the multiple sources of household income contributed by different household members. They show only the primary source of income. Space does not permit a full discussion. The example of the employment of adult children gives some insight into the multiple household sources of income, as well as the general economy. 55 percent of young adults (over 18 years of age) who were living with their parents were self-employed or employed, 20 percent were still in school. Most significantly, 25 percent were unemployed, i.e. had earned no cash income during the year of study. The high unemployment rate reflected the general state of the national economy.

National Economic Policies

During this period, the government introduced a number of stringent economic policies in response to the international markets and in an attempt to attain a more equitable society. For example, the dramatic increase in the world market price for petroleum, and the increase in the price of raw materials and of intermediate goods such as machines and their spare parts, led to the government's restriction on imports. This limited to essentials the goods sold in shops. It also limited the availability of raw materials for home industries such as weaving. This policy had a direct effect on incomes from trading and home craft industries.

In addition to introducing legislation to curtail the role of traders in marketing paddy, and to curtail the availability of imported goods, the government introduced other measures which changed the position of traders. A basic needs policy also reduced the role of traders in the distribution of many staple food items. Most food staples, such as rice, lentils, flour, sugar, dried milk, dried fish, and a number of other items were bought by villagers from the cooperative. This was because the free and/or subsidized rationing system made the cooperative's goods cheaper. Most shopkeepers could not obtain a license to sell these staples. The most important item both politically and nutritionally was rice. In 1975, the weekly *per capita* allowance was 1.5 pounds free and 2 pounds at a regulated price. The subsidized price at the time of the study was less than one third the market price for rice. This policy, plus the restriction on imports, meant that there was little in the shops to sell. To give some indication of the impact of these policies, one shopkeeper told me that before 1972 he had had a turnover of Rs.1,800 per month. By 1975 it was reduced to Rs.700. The general pattern of dramatically reduced incomes among traders must, at least in part, be attributed to these policies.

In the same vein as its policy to staple food items, with regard to coconut the government pursued policies which would protect the consumer. The decline in coconut and coconut product prices between 1974 and 1975 was, in part, influenced by the international markets, especially with regard to coconut oil and desiccated coconut. In contrast, the average export price of copra more than doubled (Sri Lanka Government 1975, 1976), and bears no relation to local prices which slumped proportionately to those for coconut. Unlike other export commodities (e.g. tea and rubber), only the surplus to national domestic requirements was exported.

According to the Ministry of Coconut Industries policy document, "Coconut Development Strategy", the government's main aim was to maintain supplies for domestic consumption.

> The objectives of government policy in the coconut sector have been, among others, to ensure an adequate supply of coconuts and coconut oil for domestic consumption. While increases of export earnings from coconut products is also an important objective, it is considered to be secondary to the objective of satisfying domestic needs. In bad crop years, exports had often to be curtailed or even banned to maintain an adequate domestic supply. To realize these objectives the government provides various subsidy schemes and agricultural support services for coconut cultivation, and instituted an export duty system to control the export of coconut products (Sri Lanka Government 1984: 8).

Consequently, prices to producers were depressed.

> The government interference in the market place altered trade flows and prevented producers from receiving the full benefit of international prices. The consumer protection policy which prevailed in the 1970s also contributed to the neglect of coconut properties and the poor performance of coconut production (Sri Lanka Government 1984: 20).

The national market affected prices and strategies employed by local merchants, whether they sold copra or coconut. Government decisions were made according to the best national interests in relation to the international market and domestic consumption needs, not the best interests of producers or petty traders. Hence, there was no cushion for the producers and their brokers when the market was glutted. During July and August, 1975, the copra warehouses in Colombo were glutted. In part the glut was due to the fact that 1975 was a year of high coconut production. This was exacerbated by a ministerial decision that no coconut oil would be exported. Therefore, the consequence of government policies was to lower the price for the consumer, the copra producer, and the coconut cultivator, and to reinforce the dependency of producers and cultivators on traders.

Another government policy which affected credit relations was a ceiling on land ownership, introduced in 1972. The maximum for one landowner was set at 50 acres, of which 25 acres could be paddy land. This was a disincentive for investing in land, and had the consequence that land was less likely to be used as collateral for credit. Although the proportion of land mortgaged to traders was but a fraction of that mortgaged to kinsmen, several traders had invested heavily in land outside the village before the period of research. In addition, the nationalization of nearby coconut estates, and a policy to offer employment to unemployed youths, reduced the employment opportunities for adults with families.

When It Is Hard to Save

In the context of declining incomes from paddy, coconut, trading and home craft industries, the demand for credit was increasing and the sources of credit were declining.

Credit played an important part in almost all households, particularly because of the fluctuating imbalance between income and expenditure. There were three major areas of expenditure: production, consumption, and emergencies. Although production is given most emphasis by planners, it was consumption expenditure (see also Heidhues, chapter 3) which dominated expenditure in two ways. In the first place, it took the largest slice of total income. In the second place, the proportion of consumption expenditure was inversely related to income: poorer households spent a larger proportion of their income on consumption than did better off households. Even in rural areas where agricultural production is high, poorer households have been reported in one study to spend an average of two-thirds of their total income on buying food (Ponnambalam 1981: 59). A larger proportion of income that was spent on food was concealed by government subsidies on most staple items.

Two major ways of coping with expenditure needs are savings and credit. Cash saving was not a long-term strategy that many households were able to pursue. Eighty-two percent of households in Polgama had no cash savings during the year of the study, which was a period of financial stringency. Perhaps more significantly, 71 percent said they had never had cash savings. This is particularly important with regard to the debate on the role of saving and capital formation for development (Firth and Yamey 1964; Howell and Adams 1980; Von Pischke 1981).[1] In contrast to saving, borrowing seemed to be a strategy employed by most households. 87 percent of households admitted that they used credit as a strategy; and 88 percent of these borrowed for consumption.

Decreasing Sources of Credit for Production and Consumption

There were several different sources of credit. Family and friends, among them moneylenders, and rotating savings and credit societies, were sources of credit which were not limited in purpose, although they were primarily used to meet daily consumption needs and emergencies. They were accessible only through a social network. Formal credit institutions such as banks gave credit primarily for production purposes, and for some long-term consumption needs, but not for daily consumption. Access was restricted by lack of creditworthiness and by bureaucratic procedure. Traders provided credit for production and consumption needs and were accessible, at some level, to everyone (Southwold-Llewellyn 1991).

Institutional Credit

Loans through institutional sources, such as banks and cooperatives, were limited to a specific purpose for a specific period of time. Access was limited to those with financial and social resources to provide them with guarantors. The introduction of pawn loans enabled loans for consumption and emergencies to be given by the Rural Bank; but the scheme was only available to those who were able to mortgage jewelry, particularly gold. Therefore, by their very structure, institutional loans were not available and useful to most people, whether because of their lack of “creditworthiness” or through the institutions’ failure to meet people’s most pressing credit needs for daily consumption.

In contrast to other forms of institutional credit, agricultural loans for paddy production in Sri Lanka were relatively accessible. With regard to coconut, both the awareness and the receiving of subsidies for seedlings and fertilizer were minimal (Sri Lanka Government 1984), and no one in Polgama received them. Officially, agricultural credit was not intended to meet consumption needs. However, since consumption needs were more urgent, credit given for agricultural purposes was often used for so-called non-productive purposes. Rural credit must be seen as fungible towards consumption. For whatever purpose they were used, paddy production loans from the formal sector ceased because of the drought and the consequent defaults on repayment. There were no agricultural loans after *Maha*, 1973-74, for Polgama and Gonnawa and the surrounding eight villages.

To reduce household consumption risks, the Sri Lankan government had had various programs to meet basic needs such as free health services and food rations. These had, no doubt, ameliorated the demands for certain types of consumption. However, daily consumption remained paramount and in a situation of economic stress it is not surprising that these ameliorative policies were not sufficient. The ILO report on basic needs summarizes the conclusions of several research projects in Sri Lanka which show that private money was a far more important source of credit.

> Even after 30 years of credit schemes the majority of farmers continue to depend on non-institutional sources of lending, although credit is granted without any form of security and at a low rate of interest (Richards and Gooneratne 1980: 116-117).

Savings and Credit Societies (Naya Dena Samitiya)

There were three death donation societies that had members from Polgama. None appeared to be functioning in 1975. Like the death donation societies, the Gonnawa Credit Society had become moribund. Similarly, five

1. Whether non-cash savings, such as saving reserves of coconut or ration sugar, are to be considered a form of saving is a matter I exclude from the present discussion.

out of the eight ROSCAs with Polgama members which had been started since 1968 had ceased to operate. Given the economic slump, it is not surprising that credit societies were not flourishing. All of these societies required regular contributions; and I suspect that this may be a reason for their malaise and is another indication of the economic depression.

Informal Sources: Relatives, Friends and Traders

Family and friends continued to make the largest contribution towards supplying cash loans and mortgages. However, as individual funds were decreasing, they too were less able to lend money.

A striking feature of this financial landscape was the small number of traders who gave loans with interest or mortgages of any sort. In fact, of all the 42 traders in Polgama-Gonnawa, only three were mentioned as giving loans with interest (*naya*); and they were all copra merchants. There were five traders (including two who also gave *naya*) who exchanged money without interest, usually reciprocally and four who gave mortgages. This is in marked contrast to the caricature of the unscrupulous trader who tricks villagers out of their land. In contrast, mortgages were most frequently given to siblings.

At the same time as the demand for credit increased, the availability of credit decreased. Production loans from the formal sector ceased because of the drought and the consequent defaults on repayment of previous loans. Few had the resources to contribute regularly to ROSCAs and other savings services. Shopkeepers were hit by the general recession. Kinsmen and friends who were themselves less well off were less able to lend money. The lack of paddy cultivation also meant that paddy was not available to be used as collateral. Consequently, traders, particularly those involved in coconut marketing, became the major source of comprehensive credit. The major credit role of traders is for daily consumption credit, in addition to providing credit for production and emergencies.

Mutual Dependence Between Traders and Households

Three of the most predominant characteristics of borrowing for domestic expenditure from both shopkeepers and copra merchants were: (1) the debt was spread over more than one creditor source, (2) the debts were for small amounts, and (3) the borrowing was frequent -- perhaps several times a week.

Those with landholdings under two acres typically sold their coconut to shopkeepers who also dealt in coconut. Those owning over two acres of high land typically had an account with a copra merchant. The pattern of borrowing was to borrow small amounts frequently. These were advances on future harvests.

Most households, even those with an account with a copra merchant, sold a few coconuts to shopkeepers on a barter basis. These shopkeeper-coconut merchants were particularly important for the landless and for those with very small landholdings who needed to maximize their credit resources. In addition to these small subsistence farmers, landless tenants and employees also sold nuts to subsist. Landlords and employers had a moral obligation to give coconuts to their landless tenants or employees for their domestic subsistence. The landless, like marginal landowners, often sold/bartered these nuts to meet other, more pressing, consumption needs.

Credit, both receiving and giving credit, was central to understanding how traders operated their businesses. Traders needed credit to secure an on-going supply of goods, to bridge gaps in income, and to finance expansion, as well as to meet the consumption needs of their own households. Traders also needed to give credit to maintain their business, since indebtedness helped to maintain an on-going relationship with customers and suppliers of agricultural crops (Geertz 1963: 36; Yalman 1967: 49). Traders operated within a hierarchy of interdependent relations as both borrowers and lenders.

A distinction between shopkeepers and copra merchants is useful for understanding how traders operated their businesses, because the two types operated with different structural constraints. There were basic differences in the way they organized their businesses with regard to management and access to credit. On what terms advances were given was a central criterion for the distinction between shopkeepers and copra merchants. Shopkeepers gave and were given advances in goods for repayment in cash; copra traders gave and were given advances in cash for repayment in coconuts.

These various contexts explain the forms of financial landscapes in Polgama and Gonnawa; but they do not explain the content of credit relationships. To do this, we need to consider the differential responses to these changing contexts. In the following part of this chapter, a discussion of the changing role of shopkeepers will be used to illustrate the content of credit relationships. For the sake of brevity, only credit relationships of shopkeepers and shopkeeper-coconut merchants will be discussed.

Shopkeepers' Changing Credit Relations with Customers

Prior to 1971, shopkeepers were a major source of consumption credit. Credit continued to be important for securing customers, but the extent of credit became limited. Shopkeepers said that the "bad state of the economy" was the major reason why they had to curtail credit. The reason they gave for the "bad state of the economy" was the government's policies, with particular regard to paddy marketing legislation, and restrictions on imports and the sale of staple foods.

Strategies for Securing Customers

Most traders started with a tea and vegetable shop. The low capital threshold of entry and the subsequent replication of these petty trading enterprises made competition to secure and maintain customers fierce. Credit in the form of advances in goods was given to build a clientele. Yet, the "generosity" of the novice trader was exploited, in effect, by everyone. It was common for a poor householder to visit several different shops each day, getting a few Rupees worth of goods on credit at each. Relatives expected, if not demanded, goods for which they often did not pay. Often, customers borrowed to the limit the new trader would give them and then no longer patronized the shop. Those that sold prepared food, however, were the most vulnerable to requests for charity from the destitute. These were typically the newest and the least capitalized of the shops.

Better established shopkeepers were less vulnerable because they were in a better position to decline custom on credit. But the problem of default plagued them all. Some said they limited credit to those who had salaried posts or who would sell them coconuts; others said they must give credit to build a clientele and to appease kinsmen. In all cases, however, the trader realized that he was unlikely to be repaid for a substantial proportion of the goods he stocked and that this was a cost of running a business. Virtually every shopkeeper, of those 34 who were interviewed on this subject, said he lost at least 10 percent on unpaid debts each month. The factuality of this is less important than the fact that it was believed to be true.

Hence, accepting defaults as a cost of business was as important for securing custom as was giving credit. Repeatedly, I was told by shopkeepers that they would only ask to be repaid once or twice. Most debtors said that they intended to repay their debts; but then realized that they could not. If the shopkeeper badgered a customer, the customer would be embarrassed, he would no longer patronize the shop, and he would be lost as a potential cash-paying customer.

To compensate for these losses, different traders had different approaches. Some charged debtors more. Some increased the prices of all goods to compensate for their losses. However, if the prices were increased unreasonably high, few would go to the shop.

The shopkeepers' customers were the most volatile. High charges, as expressed in high prices for goods, were often used as an excuse by customers for leaving debts unpaid. They could also be used by shopkeepers to discourage customers whom they perceived as a bad risk.

More typically, credit to marginal agricultural producers and wage earners (who often bartered the coconuts for their own subsistence) was limited to between five and fifteen Rupees. Those who produced an agricultural surplus could get more credit: usually between five and fifty Rupees. Wage earners with reliably good incomes, e.g. civil servants, teachers, etc., had monthly accounts.

Another strategy for both encouraging and discouraging customers was the use of politeness. Initially, a trader would give a new customer a cup of tea and a cigarette, wrap his purchases nicely, and advance credit whenever he was asked. To discourage custom, the shopkeeper might embarrass a debtor by asking him to pay his debt in front of others; this was a particularly useful way of discouraging relatives. Yet, other traders told me that they would ask for repayment once or twice, but no more than that for fear of losing the customer altogether.

A third strategy for securing customers was to sell goods at what was seen to be a fair price, and to give credit on reasonable terms. Senaratne found that shopkeepers have to counter the competition from other shops in the nearby town:

> ... by making the conditions economically attractive, as well as by providing for the purchase a background of personal relationship. Credit achieves both. A shopkeeper's skill lies in knowing what maximum of consumer credit his business can stand with safety, and then in keeping his customers happy while sticking rigidly to this limit. No shopkeeper really manages to do both (Senaratne 1971: 137).

This precarious balancing act to secure customers was particularly risky at the initial stages of business and accounts for the high rate of failures. What must be borne in mind is that there were few sanctions that a shopkeeper could use against his defaulting clientele. The most rigorous sanction any shopkeeper had was to withhold future credit, and thus lose a customer.

Moral Obligations to Give Credit

Giving credit cannot be explained solely by the economic rationale of securing customers. Shopkeepers had a moral obligation to give credit for consumption to those in need, particularly if they were regular customers, friends, kinsmen, or destitute strangers.

In the cases of the destitute and of kinsmen and neighbors, most traders believed that they had a moral obligation to give goods to those in need. Nominally these goods were given as credit, although neither party might have expected repayment to be made. The idea of moral obligations to the poor was widespread. Thompson coined the term "the moral economy of the poor" in his influential work, "The English Crowd in the Eighteenth Century" (1971: 79). Like Thompson, Scott has argued that there is a shared moral universe of what is just in peasant communities of Southeast Asia. A central principle for shaping dependent class relations is the notion, held by the poor, that they have a right to their subsistence needs (Scott 1976: 33). John Harriss has summarized the argument:

> The right to subsistence defines the reciprocal duty of the powerful, the minimal obligations that they owe to those from whom they claim labor (appropriate surplus value). The principle of reciprocity does not mean that equivalent goods and services have to be exchanged between the dominant and the subordinate classes, but that the legitimacy of the exchange depends upon the extent to which the expectations of the dependent class, rooted in their minimum needs for security, are satisfied. The argument suggests that people define "exploitation" in relation to their ideas about their minimum livelihood requirements (1982: 259).

In Polgama, "dependent class relations" of this type were limited to those few with client-patron relationships, particularly between employees and employers, and to some extent to those few with tenant-landlord relationships. In contrast, the long-term relationship of dependence of coconut cultivators on coconut merchants for consumption credit was not a relationship of dependence, but one of mutual interdependence.

The short-term credit relations between shopkeepers and their customers were based on slightly different moral principles. This was not a long-term relation of economic dependence. Credit to kinsmen was based on social, not economic, criteria; nor would the same kinsman expect advances on goods on an on-going basis unless an economic relationship had been established. In the case of credit to the destitute, many of whom were strangers, the moral obligation to give to the destitute was based on the Buddhist injunction to feed the hungry.

The Changing Credit Role of Shopkeepers

Juxtaposed to these business and ideological reasons for giving credit, there was a growing rationale for ignoring these obligations. The changing and divergent attitudes that individual traders had about giving credit to kinsmen illustrate how "... Cultural rules have a dynamic quality, capable of producing transformations in meaning and changing or redirecting behavior along new paths" (Kapferer 1976: 13). The changing contexts in which they were operating (e.g. government legislation, the international, national and local economic situation) provided a framework for these shopkeepers to conceptualize and legitimize their changes in attitude and behavior.

Thus, changes in the economic situation were used to explain certain attitudes which did not honor ideal relations with kinsmen. These attitudes were presented as different from those held in the past. Whether or not this was in fact the case is academic. What is significant is that the current economic situation was seen to legitimize evading the expectations of kinsmen for credit.

In their minds, there was a conflict between the moral principle to give to kinsmen and the economic principle to withhold credit from likely defaulters. Shopkeepers felt ambivalent about their relatives. On the one hand, "How can you say, "no", to relatives?" On the other hand, "Relatives are always jealous". Because of the "bad state of the economy", shopkeepers said they would not give credit more than a couple of times without repayment. Yet "if a person explains his difficulties, I'll give him money, even if I know he will not repay." These ambiguities were not new; but the changing context of these relationships had led to a dwindling role for the shopkeeper in the provision of consumption credit based on long-term credit relationships.

One reason for this dwindling role was that the government had curtailed shopkeepers by making a government monopoly of most basic food stuffs, particularly rice, and restricting the importation of "luxury" goods. Secondly, paddy was not used as collateral due to the government controls on its marketing and decreasing importance of its production for income. And, thirdly, there was a lowered standard of living due to high unemployment and to the failure of the paddy crop for five years; this had encouraged the proliferation of competing small shopkeepers. Consequently, capital circulation was restricted to such an extent that shopkeepers did not have a margin of profit that would enable them to sustain more than a 10 to 15 percent loss from their debtors. This helps to account for the mushroom growth and decline of shops.

Conclusions

The discourse against traders has been used by successive governments before 1977 as an excuse for the lack of economic prosperity. Yet, it was a discourse that was also manipulated by the traders themselves. The government attempted to curb shopkeepers by controlling paddy marketing and by limiting imports, which provided an opportunity for many shopkeepers to extricate themselves from their "traditional" obligations. Those starting a business with a tea shop were in the least advantageous position to extricate themselves from these obligations; and they continued to be the most vulnerable creditors. But those businesses which were able to survive to a grocery-shop stage of development were able to use this legislation to their advantage. The declining prosperity of shopkeepers was made a convenient excuse for not giving credit to customers and to relatives and friends in need.

The policies of various Sri Lankan Governments reflect the conflicting theories about the role of traders in rural development. Traders are presented as entrepreneurial innovators, as agents of stagnation operating at the margins of subsistence, as purveyors of credit which sustains the household, or as agents of underdevelopment and pauperization of these same households (Harriss 1981).

From 1971 to 1977 the United Front were in government. This was a quasi-socialist government which held the view that traders are agents of underdevelopment; but similar views were held by preceding governments. After the defeat of the United Front in 1977, the new government led by the United National Party pursued policies reflecting more neo-classical economic views about the role of traders in development. Their policies have had a profound impact on local credit relations and on the saving and borrowing behavior of the public. It would be interesting, after 20 years, to see how the financial landscape of Polgama has changed.

The period of study was one of economic stringency for Sri Lanka as a whole, as well as for the villagers in the area studied. As a consequence, there was a distortion of household income structure and credit relations from what it appears they would have been during periods of greater affluence. The distortion creates many methodological and theoretical problems for the researcher. While the factors of the multiple contexts examined may have led to a distortion of norms, they nevertheless also provide an opportunity to examine the nature of economic relations during a period of economic stress. During such a period, the principles, on which economic relations and government decisions are based, are critically tested.

This paper has been an attempt to map out some of the multiple and changing contextual factors which structure financial landscapes, and to analyze the differential responses by individuals to this ever changing landscape.

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16

Finance in Context: Exploring Diverse Exchange Conditions

Ben Crow[1]

The purpose of this chapter is to outline some of the dimensions of diversity in financial landscapes, some of the processes of causation with which diversity is associated, and some of the implications for the reform or rebuilding of financial landscapes. The chapter is primarily illustrated with results of my research on interlinked finance and grain exchange in Bangladesh.

The empirical diversity and some of the formative influences on financial landscapes can best be reconstructed (in the analytical sense) with the help of different academic disciplines, which offer perspectives sometimes overlooked in studies of financial landscapes. Historians have charted important structural shifts in financial relations, which have brought the rise and fall of groups of lenders such as trader lenders, specialized lenders, landlord-lenders, bankers, mortgagors and brokers. Economic anthropology and sociology have illuminated the diversity of the relations through which access is obtained to credit, and the ways financial relations are embedded in social structure. Political scientists and sociologists have shown how the outcome of policy directed at credit provision may depend on the structure of power in an agrarian society and the ways that financial and other exchange relations reflect that power.

Economics has been the dominant discipline in the theorization of financial landscapes. In the last decade, economic contributions to the study of financial landscapes have established a broader conception of the role of finance in development -- going beyond concern with the provision of credit, which had been an important focus of development policy after the Second World War, to encompass savings and the macro-economic implications of financial intermediation. Economics also contributed the now-prevalent model that equates all forms of lending with financial "markets" (Von Pischke, Adams and Donald 1983: 4-5). The diversity described in this chapter provides reason for questioning this equation. The agrarian concerns of economists have begun to widen, with the emergence of the "new institutional economics" (Bardhan 1989), which seeks the logic of interlinked transactions, notably sharecropping. Nevertheless, even the more subtle understandings of the new institutional economics seem to overlook much important empirical diversity. Financial landscapes in developing countries do not seem to be simple markets in which generalized commodity production, impartial regulation, the absence of power, and equilibrating processes may be simply assumed.

This chapter seeks to illustrate some of the diversity of financial landscapes and uses that diversity to question assumptions which are implicit in some contributions to the rural financial markets literature[2]:

1. Separability -- that financial relations can be analyzed independently of other production and exchange relations;
2. Duality -- that informal and formal financial "markets" are separate systems, with independent dynamics;
3. Timelessness -- that financial landscapes are detached from social and historical change.

The three assumptions of separability, duality and timelessness are commonly implied in the application of market models to the analysis of rural finance, and in the promotion of generalized policy prescriptions. If the assumptions are not true, then more empirically robust representations of competition and equilibration are required for effective analysis, and processes of policy formulation will be needed which address the historical and social diversity of financial landscapes.

In recent years, there has been a renewed interest in informal finance.[3] A more positive view of informal lenders has gained support, recognizing their ability to "provide a service to the small farmer that could not be readily reproduced by a formal financial institution" (Fuentes 1992: 7). This rehabilitation of informal finance has been associated with an upsurge of interest in the potential for linking of formal and informal financial intermediaries (Bell 1990; Germidis 1990; Fuentes 1992; Seibel and Parhusip 1992).

1. The comments of Barbara Harriss-White are gratefully acknowledged. The conclusions are those of the author.

2. These assumptions exemplify what Polanyi called the "economistic fallacy" -- "an artificial identification of the economy with its market form" (Dalton 1968: 142). Stanfield explains Polanyi's argument as follows: "... the economistic fallacy identifies an abstract model with reality, and ... considers economic behavior only insofar as that behavior corresponds to the postulates of the formal, maximizing model" (Stanfield 1986: 42).

3. The Grameen Bank of Bangladesh featured as an example of successful economic organization in the electoral campaign of President-elect Bill Clinton.

Two types of proposals have emerged from this reassessment of informal finance. Firstly, there are proposals for the establishment of planned links between banks and informal savings and credit associations and/or NGOs (Seibel 1985). Secondly, there are proposals for the provision of bank funding to chains of money-lenders (Stiglitz 1991; Adams and Meyer 1991; Harriss, chapter 17). This chapter concentrates on the second type of proposals and suggests that careful consideration is given to particular forms of lending within specific social conditions.

The chapter has two sections. The first section provides an overview of interactions between financial landscapes and social and economic change in Bengal during the last century. This section begins to make the case that financial "markets" cannot be adequately understood separate from their social and political context. The other section describes in some detail two financial landscapes in Bangladesh, in order to illustrate some of the problems which may arise if there is incautious interlinking of formal and informal finance.

Historical Change of Rural Lenders in Bengal

Historical studies of the development of finance can illuminate the relationship between long-term social and economic change and the types of lenders and types of finance predominating in a particular period. Why do different categories of lender emerge to prominence? This dimension of historical variation is sometimes overlooked when financial provision is assumed to be a simple, unchanging market.

There are two excellent sources describing patterns of change in informal finance in Bengal. With a detailed historical study, Bose (1986) has analyzed the interaction between social and economic change and the rise and fall of different kinds of lending in the three decades prior to independence. Sen (1988) has continued this story up to the present day with a detailed empirical study of the rise of new financial agents in one area of contemporary Bangladesh.

These sorts of accounts highlight some of the influences on the topography of financial landscapes. They

Table 1: Brief Overview of Rural Finance in Bengal Since the Late C19th.

Period	*Types of Finance*	*Causes of Change*
To late C19th	Specialized moneylenders	
Late C19th --1930s: "heyday of the creditor"	Landlord- lenders	Bengal Tenancy Act of 1885 sets limits on return from renting, expansion into credit provision provided landlords with highest returns;
	Trader-lenders	Expansion of jute cultivation enlarged credit needs of cultivators; external merchant capital flowed in to extract produce. Small traders became brokers in an elaborate credit marketing chain.
1930-1945: collapse of credit system	Rich cultivator lenders	During the Great Depression the flow of external funds dried up. Landlords stopped lending when returns to cultivation decreased as a result of collapse of product prices. Trader lenders stopped because the flow of external finance had stopped. These lenders were partially supplanted by rich peasants.
1945-1960	Specialized lenders become important again	Legislative measures made traders and landlords wary of returning to credit sphere, but growth of production contributed to demand for finance.
1971-present: emergence of new groups of lenders	Specialized lenders; rich cultivators; input entrepreneurs; *dadaon* brokers; traders	Rapid increase in number and diversity of lenders, particularly in the four years after Independence.

Sources: Bose 1986: chapter 3; Sen 1988.

suggest some of the ways in which the commercialization of production, the expansion of external merchant finance, the actions of state regulators, the state of the world economy and, not least, the rise and fall of particular social groups may interact with processes of lending and borrowing. Table 1 gives a considerably simplified overview of some of the changes and social processes which Bose and Sen describe.

Bose highlights the spread, at the end of the last century, of financial transactions linked with tenancy or with the marketing of jute. Specialized moneylending was eclipsed by two factors, the squeezing of the returns to renting out land, and the expansion of commercialized jute cultivation. On the decision of landlords to turn to lending, Bose (1986: 102) writes:

> Rates of return from alternative sources of investment, especially in the urban areas, held little promise. It was, therefore, a question of playing the old game [of drawing on the production of their tenants], but according to the new rules of the credit market. This adaptation was made possible in the context of the widening market for peasants' produce.

This "widening market" was the development of jute production for the world economy. Provision of external capital through an intermediary chain hastened the economic integration of scattered small peasants (Bose 1986: 102):

> The expansion of the jute economy from 1906-7 enlarged the credit needs of the peasantry and increased manifold the importance of the form of credit known as *dadon* or advances on the security of the crop. As merchant capital flowed in to extract the valuable commercial crop, many country traders became commission agents of the purchasing companies in an elaborate marketing chain. Some also employed their own small capital. The vast annual flow of funds from the financial superstructure that was distributed in the form of *dadon* [became integrated with] the smaller *lagni* or usury capital that circulated in the countryside.

In areas where the independence of cultivators was somewhat more established, that is, in much of East Bengal, intermediaries and landlord-lenders withdrew from finance ("bonds of dependence were snapped"). Bose's account thus notes a connection as far back as the early nineteenth century between external (formal) finance and informal finance. In the Great Depression of the 1930s, however, the flow of merchant finance dried up and world prices for jute collapsed. The decline of the credit system was one of the precursors of the Bengal famine of 1943 (Bose 1986: 275-277). It also contributed to long-term changes in the structure of credit provision. In areas where landlords had greater sway over the organization of production, that is, much of Central and West Bengal, small lenders fared badly, but the more powerful landlord-lenders were able to consolidate ties of debt to peasants and tenants within their domain (Bose 1986: 144).

Changes in the world economy indirectly created the opening, in East Bengal particularly, for rich peasants to reconstruct the financial landscape. The collapse of the credit system led to lower living standards, but gradually and to a lesser extent "cultivators in a position to lend stepped into the breach" (Bose 1986: 122). These lenders had grain to lend rather than cash. Much of their lending was thus in the form of paddy loans.

Table 2: Types of Lenders in a Backward Area of Bangladesh in 1986

Lender Type	*Distribution of Lenders*	*Comment*
Professional	29	Moneylending is their main income source
Rich peasant	8	Cultivation provides their principal source of livelihood
Input-entrepreneur	11	Fertilizer wholesalers and retailers and irrigation equipment owners, mostly big landowners, may be trading in other commodities
Dadon-broker	11	These lenders are intermediaries for large financiers resident in urban areas; similar to company agents during British rule, supplying large part of rural credit in addition to acting as marketing intermediaries; 40 to 60 percent of marketed grain is exchanged through such brokers
Trader	11	Includes grocery shops, cloth merchants, kerosene dealers, petty retailers, for whom moneylending is a subsidiary source income
Others	32	Includes friends, relatives and neighbors

Source: Sen 1988, Table 1, p.35.

Table 3: Distribution of Informal Credit by Types of Transaction and Lender

Type of Transaction	*Percentage of Total Loan per Lender Type*				
	Professional	Dadon-*Broker*	*Input Entrepreneur, Trader and Rich Peasant*	*Others*	*Totals*
Kind-kind	2.0	0	0.5	0	2.5
Cash-kind[4]	10.2	13.9	3.9	6.2	34.3
Cash-cash	3.1	0.5	0	0.1	3.7
Land mortgage28.9 (usufruct)	0	26.4	4.3	59.5	
Totals	44.2	14.5	30.8	10.6	100.0

Source: Sen 1988, Table 13, p.64.

As at earlier turning points in the development of the financial landscape, legislative action influenced the direction of change after the end of colonial rule. Legal restrictions on moneylending were apparently sufficient to deter a widespread return of trader- and landlord-lenders, and there was some growth of a new generation of specialized moneylenders meeting the needs of a commercializing agrarian economy. Then, as Green Revolution technologies were adopted on an increasing scale during the late 1960s and particularly after the independence of Bangladesh, professional lenders were partially displaced as many new categories of lender came onto the scene.

Sen's detailed study provides some information about these new lenders. His study was carried out in backward areas of Bangladesh subject to regular flooding, with high levels of tenancy and relatively low levels of productivity. From this study it is possible to fill out the picture of the contemporary financial landscape. The distribution of lenders operating in the areas investigated is summarized in Table 2. The relative importance of different types of credit for each category of lender is described in Table 3.

One striking aspect of Table 3 is that cash lending repaid in cash, constitutes less than 4 percent of informal financial credit in this area. The remaining 96 percent is provided through interlinked transactions of different kinds. The most significant categories of lending are the usufructuary mortgage (in which the lender obtains use of the land) and the cash loan repaid in kind.

Sen notes that "an overwhelming proportion of lenders are closely linked with [the] modern sector" (Sen 1988: 48). Much of their finance comes from banks or government departments, and some of the lenders also save with banks for part of the year. He also notes "the emergence of financial brokers between informal and formal credit market as yet another example of linkages of "traditional" moneylenders with the modern sector" (Sen 1988: 48).

Interactions of similar kinds are not confined to Bengal. Thus, Bell notes that recent World Bank (1992) research has indicated the rise of trader-lenders in areas where Green Revolution changes have been most pronounced. Cultivator-lenders and shopkeeper-lenders remain in business from Bihar to Punjab, but:

> The really intriguing feature of the data, however, is the importance of nonresident traders and commission agents as sources of finance in the most commercialized areas...commercialization is associated with heavier borrowings, not only from institutions, but also from traders and commission agents. Indeed the average amount borrowed with output interlinking in Punjab greatly exceeded the average amount borrowed from all sources in Andhra Pradesh and Bihar. The same pattern was also evident *within* the latter states ... Thus trade and (interlinked) moneylending flourish with advancing commercialization as simple intuition would suggest (1990: 308).

A similar rise in trader-lending associated with commercialization is reported from the Philippines (Esguerra and Meyer 1992: 162) and for Northern Nigeria during the 1920s when merchant capital sought securing supplies of cotton (Shenton and Lennihan 1981).

Contrasting Contemporary Financial Landscapes in Bangladesh

The historian's perspective provides an overview of some of the influences on temporal variation in financial landscapes. To that we need to add the dimension of spatial diversity. What is the range of diversity in rural financial landscapes, and with what is that diversity associated? Spatial variation has not generally been

4. Sen does not report kind lending repaid in cash, such as the paddy loan noted earlier.

Table 4: Importance of Credit Sources in Advanced and Backward Areas

Source of Loans	*Number of Households Taking Credit from Different Sources*	
	Advanced Area	*Backward Area*
Banks (cash-cash)	9	3
Moneylender (cash-cash)	4	3
Friends and relatives (cash-cash)	19	7
Paddy-cash loan	12	7
Cash-paddy (price-fixing) loan	0	38
Loans repaid in labor	0	3

adequately captured in large-scale surveys or in economic statistics. To understand some of the remarkable local diversity of financial arrangements in the rural areas of developing countries, it is necessary to turn to detailed, local studies.[5]

In the course of an investigation of grain markets in Bangladesh, the contours of linked credit and output landscapes have been revealed in some detail for two rural areas (Crow 1989; Crow and Murshid 1991, 1992). Description of the financial arrangements in these two areas, which represent two poles in the changing conditions of the country, provides a basis for thinking about how real financial "markets" function and change, and how they would respond to such proposals as the interlinking of formal and informal sectors.

The two areas were a rapidly growing area of agricultural production (Bogra in the North West, with 6 percent annual growth in agricultural output) and a slowly growing one (Noakhali in the South, with negligible growth). In each area, four villages were selected with a range of remoteness from urban centers and transport facilities. This section describes the financial landscapes of the four villages in the rapidly growing area and the two more remote villages in the slowly growing area and are referred to here as "advanced" and "backward".

The "backward" area has been settled relatively recently. It is land which was eroded in the 1950s by riverine action, and resettled after the construction of a large earth embankment in the 1960s. A land-grabbing process employing force and false legal claims resulted in new owners, organized in factions, gaining control of most of the land. These new landowners installed new migrants as sharecropper tenants. Trade and financial institutions have been constructed subsequently in the shadow of the considerable power remaining with these absentee landlords and their associates.

The "advanced" area has a longer history of continuous cultivation. Financial relations appear to have followed a course similar to that described in Table 1, except that in this area the most prevalent lenders are rich cultivators. Both the large land holdings established under *mughal* rule and specialized moneylending seem to have been destabilized during the 1950s by legislative action and the vulnerability of Hindu lenders and landowners in an Islamicized order. The majority of cultivators are owner-occupiers.

Tenure and exchange patterns, growth characteristics and traders' reports of contractual forms, suggest that the two financial landscapes described may each correspond to approximately one third of the countryside of Bangladesh. One dimension of the contrast between the two financial landscapes is highlighted in Table 4. Cash-cash loans, of various origins, predominate in the advanced area, whereas interlinked cash loans repaid in paddy predominate in the backward area, fixing the price of grain at harvest time. The more complex financial landscape associated with this type of interlinked transaction will be described first.

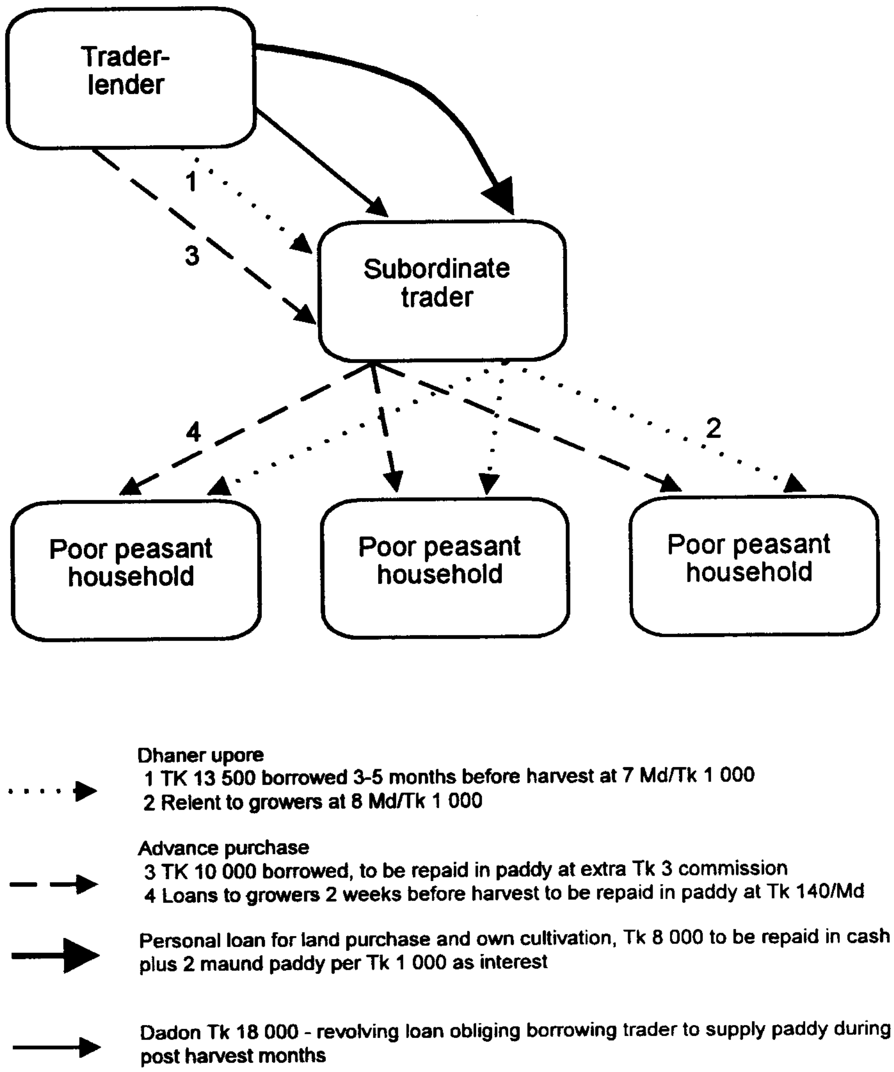
Financial Landscape in a Backward Area

When the cash-paddy loan of the backward area is followed back to the lender, an intermediary trader-lender is found (Sen's *dadon* broker in Table 1), taking loans from large traders in a nearby town. The diverse financial transactions regulating their financial dealings is illustrated in Figure 1. An intermediary was borrowing under four different contractual arrangements from a single trader-lender. Two of these contracts are for on-lending to peasant cultivators. The financial arrangements for this and other such intermediaries fall into two categories:

1. Loans for on-lending to peasant cultivators that fix the price for the producer and can thus be termed price-fixing loans;
2. A revolving loan establishing the personalized monopsony of the trader-lender for at least the duration of the loan, that is, a trade-tying loan.

5. For an overview of some of the diversity of agrarian credit in South Asia, see Harriss in this volume.

Figure 1: The Finance of One Intermediary in a Backward Area of Bangladesh



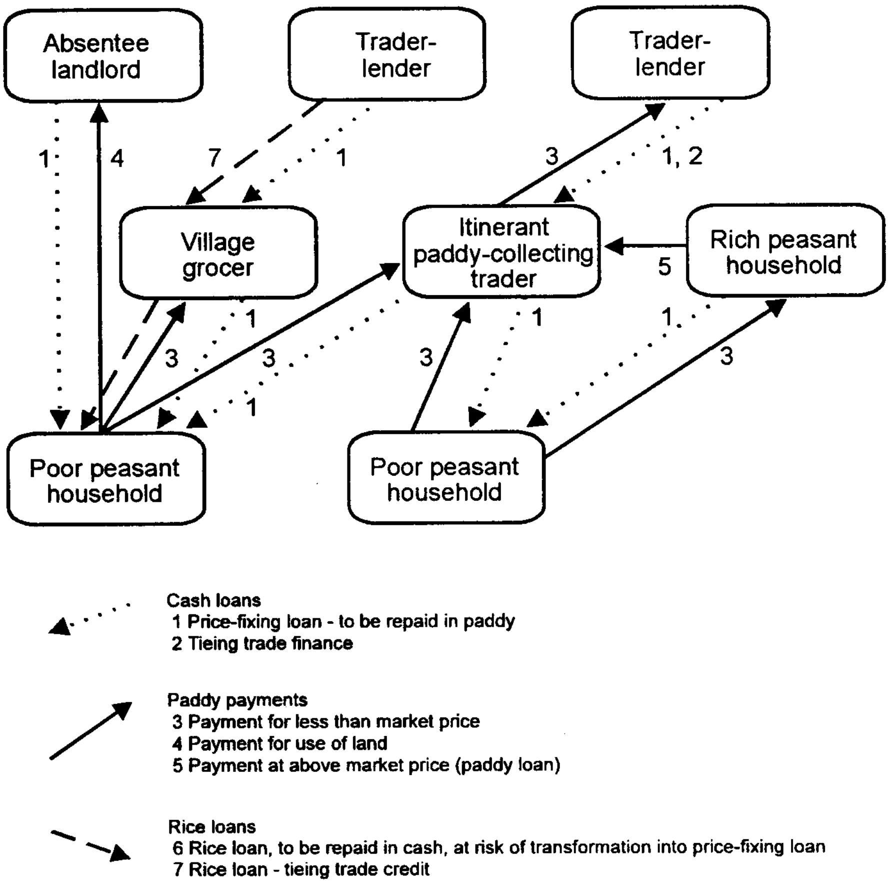
These two types of transaction are the main contractual forms linking cultivators, intermediaries and trader-lenders in this backward area (Figure 2). Trader lenders obtain some of their funding from banks. Two implications of this complex landscape are important: the cost of the hierarchy of interlinked transactions and its protection from competition.

One Consequence of Price-Fixing. This hierarchy establishes expensive markets. Price-fixing loans reduce the price which borrowers (peasant producers) get for their output by a fraction varying (in the years of study) from 25 percent to 54 percent. This is equivalent to an interest rate ranging from 60 to 200 percent per annum. Traders recall prices in previous years which imply comparable losses to the producer. In these villages, 42 percent of marketed output is subject to this price reduction.

The sale price loss can be conceptualized in several ways: a “forward price” through which the producer establishes a price before the harvest, a risk premium for trader-lenders, cost of intermediation, and maximization of trader-lender returns from a position of power. Whichever of these explanations is put forward, the implications for the producer price remain the same: this interlinkage between finance and grain markets makes borrowing expensive.

The Hierarchy and its Protection. The hierarchy appears unstable but has dominated the financial landscape in this area for two decades. It is vulnerable to competition, which provides higher grain prices, lower interest rates, cheaper transport, or some combination thereof. During the time of our study this competition was kept at bay by a combination of entry barriers: selective physical security (from robbery), financial security (from excessive default), a transport cartel, and control of information (Crow and Murshid 1992). Many different types of intermediaries make transactions which are themselves interlinked. They include the following: paddy collecting traders, rice selling traders, village stores, small- and medium-scale mills, households processing

Figure 2: Hierarchy Collecting Paddy from the Backward Area



paddy into rice, near destitute households making tiny loans. The relationships which these intermediaries or independent petty lenders enter into are strongly influenced by the practices, costs and interest rates established by the hierarchy as a whole.

Personalized Monopsony and Perverse Risk Transfer. Price-fixing loans determine the terms of exchange in the season prior to the harvest. Trade-tying loans mediate the operation of post-harvest trade and take a variety of forms. Retailers take loans from suppliers, and or purchasers, which establish personalized monopsony or monopoly. Most urban rice retailers, for example, are funded with such loans. In this area of backward agriculture, trade-tying loans finance both the grain trade and small-scale household processing.

Trade-tying loans do not establish prices but they do create a personalized monopsony or monopoly, with implications for the bargaining between the two. Thus a paddy-collecting trader who borrows from a trader is committed to selling all his paddy through the lender for at least the duration of the loan. Village shopkeepers who take a trade-tying loan (perhaps in rice) from a rice wholesaler are committed to buying rice only from that wholesaler.

In the case of intermediary traders taking this type of loan, all the grain they obtain has to be sold through the lending merchant. This monopsony increases the market share of the lending merchant. Crow, Murshid and Rashid (1991) has shown that there is also an indirect effect on prices. Small traders using this loan after the harvest receive 7.5 percent less when they sell their grain compared to the price obtained by traders who are not tied to their buyer. The effect of this interlinked transaction is thus to increase the rate of return of large traders at the expense of small traders.

The taking of the loan obligates the borrower to make regular deliveries of paddy. The lender undertakes to sell that paddy on a commission arrangement and thus takes no risk of price fluctuation. In practice, the smaller borrowing traders complain that their inability to monitor or enforce sale agreements with the lender leads to widespread manipulation and fraud which exacerbates the risks of price fluctuation which they incur.

For example, the combination of broking and wholesaling roles (which is characteristic of trader-lenders) can allow an enterprising lender to extract the benefits of a rising market while avoiding the costs of a falling market. Thus when the broker expects the price to rise, he may offer the borrowing trader a fixed price sale of the grain, rather than a commission transaction. In this way, he can take advantage of any price fluctuation. The borrowing trader may not be given a choice. Alternatively, with an element of fraud, the broker may simply report selling the paddy at a lower price, at an earlier date. Borrowers report their suspicions that these and other manipulations occur.

In addition to the transfer of price fluctuation risks to intermediaries, the costs of cultivator default (on price-fixing loans) are also transferred to the intermediary. Rather than the costs of loans being justified by the risks inherent in agricultural lending, it seems more appropriate to describe these interlinked transactions as establishing a perverse transfer of risks from large lender to small borrower.

Financial Landscape in an Advanced Area

Trade and lending chains in the advanced area are shorter and simpler than in the backward area. There is no hierarchy of interlinked transactions. The most common form of credit is an interlinked kind-cash loan, termed a paddy loan. In the case of a paddy loan, cultivators make loans of paddy to be repaid in cash at a higher than prevailing price. These loans are an important form of finance for merchants and for some poor peasants in the advanced area. They give better returns to rich peasants than direct involvement in the market, because they reduce marketing costs and the risks of price fluctuation.

In the advanced area, paddy loans establish a stream of credit which flows in the opposite direction to that found in the backward area. In the backward area, it is primarily merchants who lend to cultivators (mainly for production). In the advanced area, rich peasants provide working capital loans in paddy to merchants. The extent to which this happens in the backward area is much less. Whereas merchants finance production in the backward area, producers finance trade in the advanced.

Uncertain Dynamics of Interlinked Landscapes

The interlinked transactions of the backward area seem to establish conditions of exchange which are unfavorable for producers and favorable for trader- and landlord-lenders. By contrast, the financial landscape seems to be favorable for owner-occupiers in the advanced area, and less beneficial for traders. In this latter case, however, the influence of interlinked transactions is less significant in number and the price differences are smaller in magnitude.

Long-term processes of change in these contrasting financial landscapes can only be partially understood. There are some indications, nevertheless, that the landscape of the backward area is associated with opposition to technical change in agriculture. An innovative Dutch aid project was opposed by the urban leaders dominating the backward area partly because it threatened their hold on land, possibly also because it threatened the hierarchy of interlinked grain and credit transactions (Crow and Murshid 1992: 59). Study of landlord-lenders in another backward area shows that they are not as likely to adopt new technologies such as irrigation: “Given the comparatively high rate of return from the sectors other than crop production, the optimizing moneylender-cum-landlord would allocate less resources to HIV cultivation and more resources to other sectors” (Sen 1988: 49).

The response of these interlinked contracts to changes in output price, or in implicit interest rates, is not easily predicted. In themselves, price-fixing loan contracts constitute a perverse price response because lower (grain) prices lead to increased supply. A producer-borrower with inelastic demand for credit will be forced to supply more grain to obtain a loan as the price of grain falls. This assumes that there is a relationship between prevailing price-fixing loan rates and the price of grain negotiated separately. If this assumption is incorrect, then the implications of the loan are still more complex.

Implications

Detailed empirical investigation is required in the process of theorizing financial landscapes and making suggestions how they might be improved or reformed. In the case of Bangladesh, the outlines of different sets of financial relations are beginning to be visible, and two preliminary points can be made on the basis of these outlines.

The first is further corroboration for the finding that in these financial landscapes formal and informal finance are already strongly intertwined. The trader-lenders and landlord-lenders in the backward area have access to bank finance at low interest rates (6 percent at the time of the study) which they partly on-lend at much higher rates to traders and cultivators. In the advanced area, cultivator-lenders almost certainly have access to cheap bank finance.

The second point relates to how these landscapes would respond to initiatives to increase the flow of formal finance through informal institutions. The finance and output hierarchy described in the backward area does not appear to be an effective vehicle for expanded credit provision either to encourage productive investment or to provide less vulnerable livelihoods. An increase in the flow of finance from the formal sector in this context could increase the resources and social power of those trader-lenders and landlord-lenders who seem to be opposing technological innovation. Personalized monopsony, perverse risk transfer, and uneven market organization could all be strengthened, with deleterious consequences for growth, living standards and vulnerability.

In the advanced area, an expansion of formal finance to cultivator-lenders would add to the growing power of this group. It is doubtful if this would lead to increased availability of paddy loans to poor peasants; this would require empirical investigation.

Public Action and the Integration of Financial Markets in Social Structure

The experience of government provision of credit provides another interesting window on the diversity of financial landscapes because it illuminates the way that government can be seen as a part of the social structure rather than an independent external institution, as it is usually portrayed in market models.

In this case, academic inquiry has sought to understand why cheap credit provided in a range of government programs in many developing countries has not proved accessible to smaller, poorer borrowers. Two views of this failure have been put forward, one arising from a market model of financial landscapes, a second, relating to specific conditions in Bangladesh, resting on a more detailed understanding of a particular social structure.

Writers using a market model of financial landscapes (Adams, Graham and Von Pischke 1984; Von Pischke, Adams and Donald 1983) have suggested that in conditions where the price of credit is fixed and demand greatly exceeds supply, credit will be rationed to larger, richer borrowers because the costs of lending to them will be less than the costs of lending to smaller, poorer borrowers. This market model makes an implicit assumption of separability: it is not necessary to know about the social context within which credit programs are introduced.

Two papers by McGregor (1988, 1989), taking the example of government credit programs in Bangladesh, contest the analytical and empirical foundations of this explanation, and suggest an alternative. McGregor argues that the market model is inadequate on its own terms, because it addresses only “the supply conditions of a profit maximizing agent with some degrees of monopoly power” (McGregor 1989: 472) without describing conditions of credit demand or adequately characterizing the relation between formal (institutional) and informal (moneylender) provision of credit. He goes on to suggest that the model is tautological: it sets out to explain why the poor are excluded from formal credit provision and its empirical support is provided by the observation that subsidized credit is appropriated by larger, richer borrowers.

McGregor accepts that credit is rationed, but in place of costs of lending as the principal determinant of credit allocation, McGregor puts pre-existing social hierarchies through which patrons provide resources to clients. He argues that credit provision according to rules which gave preference to direct allocation to the poor, would constitute a threat to the social order: “If credit is an important aspect of the power base of local patrons, then the ability of bankers to challenge that power base by offering clients an alternative channel of access to credit, must be limited” (McGregor 1989: 479).

In Bangladesh, most credit programs have not established a direct relation between banks and the target population but have allowed local officials or a specialized agency to mediate. This introduction of local credit brokers, McGregor argues, enables adaptation to the social order: “The brokerage structure of access to formal credit thus represents a highly convenient mechanism for defusing a potentially volatile situation” (1989: 479). Tension between national rules and local expectations can be resolved by adapting the resource flows brought by development to fit existing patterns of social organization. So, as a result, credit is allocated to powerful patrons who then lend to their clients.

The two explanations for credit allocation to the rich need not be exclusive. The tendency for bank managers and other formal credit institutions to recognize existing structures of power and resource distribution in their credit allocation can be reinforced by considerations of lending cost minimization.

The two views of financial landscapes -- repressed credit markets or socially embedded credit programs -- also provide two different perspectives on the wave of innovative non-government programs most frequently associated with the Grameen Bank of Bangladesh (see Ghate, chapter 8). McGregor argues that this “new banking” succeeds because it is designed to avoid “the strong tendency for credit to be captured by powerful sections of the community” (McGregor 1988: 470). By contrast, the success of these programs can also be attributed to their ability to minimize transaction costs (Stiglitz 1991), or at least to transfer the costs to the clients.

This is a very brief overview of what is clearly a complex question: the interaction between new credit initiatives and entrenched social structures. It indicates, nevertheless, that there is a question about the design of financial policies which ignore the embeddedness of financial relations in the social order. McGregor suggests that both the failure of several waves of credit innovation, and the success of the “new banking” can be explained in part through an understanding of how different initiatives interact with social structure -- the social relations of dominant groups and the organization of borrowers, that is, subordinate groups.

Conclusion

This chapter set out to: (1) question a set of implicit assumptions about rural financial markets in the developing world, (2) establish, from empirical examples, some of the factors influencing financial landscapes which appear to be omitted or underplayed in the market model, and (3) indicate the implications for the evaluation of proposals for the linking of banks and informal finance.

The following assumptions have been shown to be misleading: first, financial relations can be analyzed independently of other production and exchange relations ("separability"): the social meaning, and economic consequences, of particular contracts may vary from one social context to another (sharing risks in one, maximizing lender returns in conditions of unequal bargaining in another). There is increasing recognition that interlinked transactions are widespread in some areas and may be growing in importance.

Second, informal and formal financial "markets" are separate systems, with independent dynamics ("duality"): historical accounts indicate interactions between institutional finance and change in informal financial relations, and careful, contemporary investigation reveals significant transfers of credit from banks to informal lending.

Third, financial landscapes are detached from social and historical change ("timelessness"): the examples in this chapter suggest that financial relations are not separable from the structure of social and economic relations in which they are found.

In broad summary, this chapter suggests that the character of financial relations can be influenced by forms of production (and the appropriation strategies they incorporate or make possible), by class formation including the rise and fall of different types of lenders, by forms of governmental intervention, and by market regulation which may reflect local power structures. Table 5 sets out some elements of exchange diversity and

Table 5: Elements of Exchange Diversity

Landscape of Exchange	*Some Elements of, and Questions About Diversity*
General features	How are market institutions and regulatory arrangements influenced by social power?:
(Extent of generalized commodity production and institutional structures of exchange)	- do tied contracts create unequal bargaining, personalized monopsony or monopoly? - is security and crime partial to particular groups of lenders or traders? - is collective action in relation to transport, labor, processing, access to bank finance partial to particular groups? - do local weights and measures (e.g. complex implicit interest rates) hinder price comparison and information flow? - does segmentation by gender and ethnicity create barriers to access or participation? - do dispute and contract adherence procedures give even conditions for all types and groups of participants? - which groups gain access to finance as a result of "screening technology"? - how are market ownership and revenues organized? Forms of exchange regulation (self-regulation, state, other, mix) How important is non-monetized exchange?
Land	Prevalence of sharecropping and usufruct mortgages; does social power derive from land holding?
Money-interlinking Usufruct mortgages	In what ways do interlinked loans influence prices, risks and transaction costs? What exactly are the implications of loans against land? Who cultivates? How is labor provided? What is the term of the loan, and conditions for repayment?
Labor	How prevalent is sharecropping? What are its implications for labor use, for risks and storage costs, for tenant consumption and credit needs, and for all transactions between tenant and landowner?
Commodities	Do interlinked transfers generate distress sales?

a few of the questions which need to be broached in relation to financial and commercial provision.

The implication of these points for the proposal to link informal and formal finance is similar to the conclusion Fuentes arrives: "...a much closer examination of the social relations that operate in the village is needed.." (Fuentes 1992: 25). Whilst there are apparently success stories from the linking of formal and informal finance in particular contexts, it is clear that the diversity of financial relations could lead to expensive failures if the generalized proposal of rehabilitating moneylenders is taken seriously.

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17

Moneylending and Modern Times: Informal Credit in Thailand

Dirk Steinwand

The recent literature on rural finance emphasizes the important role played by various informal lenders. In Thailand, however, their share of total loans has declined from about 90 percent to 30-50 percent between 1965 and 1991, according to official figures (Thisyamondol et al. 1965; Siamwalla et al. 1990; Onchan 1992). This decline is largely explained by the rapid expansion of the loan portfolio of the BAAC, the Thai Bank for Agriculture and Agricultural Cooperatives (Quinones and Encarnacion 1988). Researchers expect a further decline in the market share of informal lenders in the course of economic development. Their future role is seen "as a complement to formal finance", operating in "specific niches" of comparative advantage (Asian Development Bank 1990). According to ADB only the remote, backward areas will probably remain a stronghold of informal lenders, where they serve the credit needs of the poorer segments of society. Their proximity to their clients reduces transaction costs in the predominantly unsecured credit-business.

This chapter reports on a survey of the financial landscape in a Thai village located only 70 kilometers east of Bangkok (see also Steinwand 1991). Research was conducted from January to June 1990. The village is situated in the Bangkok-Chonburi area, which is by no means a backward, remote area, but rather characterized by tremendous economic growth. Its future is seen by Thai officials as "one long megalopolis, interlinked with certain breaks of rural areas, but basically... one long urban, industrial, recreational zone" (Bangkok Post 8.2.1990). The chapter will illustrate the variety of borrowing and lending patterns against the background of specific economic activities. It will focus on the changes in these patterns which have resulted from the rapid economic growth in that region and suggest that the scope of responses of informal financial activities to "modern times", at least in the medium term, is wider than commonly assumed. They raise doubts about the results of the nation-wide surveys of recent years and the figures on the decline of informal finance market share.

The Village

For a profound assessment of borrowing and lending patterns it is necessary to take a look at the social organization and stratification of the village, as well as its major economic activities. When, some 50 years ago, a coastal road from Bangkok to Chonburi was constructed, that road divided Chonburi's sparsely populated brackish water area into a salt-water-dominated coastal strip and a freshwater-dominated hinterland. Settlement followed gradually, forming strung-out villages built along both sides of the road, with some small market towns in between. The majority of people have been living there for about 30 years now, and there is still space left for further settlement. Identification with the local village is low, with little cooperation beyond family level, except for some work-party and ROSCA arrangements with strictly organized reciprocity.

The research village P. comprises 55 households. Almost half of them are landless, the remainder own between 10 and 60 *rai*, on average about 30 rai (approx. five hectare)[1]. Major economic activities are salt-extraction on the coastal side of the village and freshwater fish-farming on the opposite side. Together they make up the most important part of most households' income.

Economic Activities

The specific requirements for the production of fish and salt differ in many respects. Fish are raised in shallow basins. Once or twice a year the basins are pumped empty, the fish are taken out, and sold to traders in the next market town. Most income is generated during these periods. This labor-intensive work is organized among the fish farmers through work-parties (*longkaeg*). Breeding hardly requires any capital. Only occasionally are the fish fed with grass, obtained from the dams enclosing the basins. Nearly all household food, apart from the staple rice, is grown around the farm houses or alongside the basins. Fish for daily consumption are obtained from a *klong* (channel). Although integration into the market economy is fairly advanced, the fish farmers can rely largely on subsistence production during the extended periods without income.

1. 1 *rai* = 1,600 m^2

Salt is extracted from sea water, conducted into levelled fields on the coastal strip. This work is limited to the dry season, roughly from December to May. To shovel together and transport the extracted salt from the fields into sheds for storing, the salt farmers recruit labor from the landless households on a daily basis. Their wages are the major expenditure for the salt farmers. Salt is sold to various traders during the entire salt season, but in recent years there has been a tendency to store the salt to profit from fluctuations in the salt price. However, such speculation is restricted by the poor facilities to store the salt during the rainy season. Usually most of the salt is already sold by the end of the salt season, leaving the farmers without any further farm income for about six months. Unlike the fish farmers, the salt farmers cannot bridge periods of no income with subsistence production, as they live on salty, barren ground. For all their basic needs, which even include fresh water at the peaks of the dry season, they rely upon the market. Both fish and salt production are labor-intensive but use little capital.

Economic Boom

Some 20 years ago, construction of a new four lane highway was begun linking Bangkok with Chonburi. In the following years labor-intensive light engineering companies (textiles, electronics, computer equipment) settled in the region that became gradually included in the outskirts of Greater Bangkok. Of the invested capital, 70 percent came from Japan, Taiwan and Hong Kong. During the second half of the 1980s the annual economic growth rate went up to 30 percent in the region, compared with approximately 10 percent in Thailand as a whole (Asia Week 9.3.1990).

The economic boom involved several changes for the area. First and most importantly, the boom caused a real estate fever and an explosion of the price of land. Up to the late 1970s the infertile coastal land could be bought “for a song”. In the following years land increased in price from roughly Bt30,000 per *rai* in 1985, to Bt300,000 in 1988, and Bt1.3 million in 1990 (Bangkok Post 5.5.1988; own sources)[2]. All households have profited from the boom. The newly established factories provide jobs for unskilled labor. They thereby offer new and quite attractive sources of income to the landless, making it increasingly difficult for the salt farmers to recruit local labor. About half of the land-owning households have at least one family member working in a factory, enjoying a regular income. Moreover, these households profited from the fact that the boom caused demand for fish and salt to increase and prices to go up correspondingly. In comparison with villages in the Northern and Northeastern provinces, people in P. are quite well-off. Only a few households live in real poverty, and the majority have managed to acquire consumer goods like radios and electric rice cookers, while TV-sets, refrigerators and even cars have begun to find their way into the better-off households. The rise in land prices also had a profound impact on the social stratification. While the income gap between the landless with an average annual income of Bt25-50,000, and the landowners with Bt80-150,000 is still moderate, the gap in terms of fixed assets has widened tremendously.

The Financial Landscape

Over 70 percent of the households in P. are indebted to a whole series of lenders. In the main, one can observe a twofold function of credit in rural societies. Besides expenses for social, cultural, life cycle events or house building, capital is periodically needed to cope with seasonal shortages, as most income is concentrated around harvest times. Secondly, capital is required to purchase farm inputs in modern capital-intensive agriculture. In P. however, neither of these purposes are particularly significant. Agricultural production in P. is not very capital intensive and people employ traditional methods to cope with seasonal shortages (savings, reduction of consumption, etc.). Furthermore, the recent availability of regular factory income has clearly been an additional help in easing the situation. Therefore, we have to assume that indebtedness in P. is not simply caused by external forces, but is based on deliberate decisions of the individual households. To understand better the logic of indebtedness we necessarily have to make distinctions between different kinds of debt.

In the following I would like to present a set of different credit institutions. Here the notion institution does not mean the rural bank branch in the neighborhood, but rather North’s concept of “the humanly devised constraints that shape human interaction... (and) structure incentives in human exchange, whether political, social or economic” (North 1990: 3). From that point of view -- and, as far as it was possible to ascertain, it is the view of the local people as well -- there is only a limited interchangeability between different credit institutions: as Bailey put it, “all of these different kinds of loans are kept in separate compartments and governed by different conventions of behaviour” (Bailey 1964: 115). The performance of these credit institutions, their response to economic development, etc., can only be understood if one takes into account all the social, economic, psychological and legal aspects of a specific institution. Therefore, we must distinguish between the

2. US$ 1 = Baht 21 (1990).

rather comprehensive idea of a set of credit institutions as laid down here, and the concept of the segmentation of rural credit markets that focuses on financial aspects only.

As will be shown below, there are both similarities and differences as regards the individual features of these credit institutions. The common distinction between formal and informal credit is only one of a number of possible distinctions.

Family-Based Credit Institutions

About 17 percent of all loans in P. are allocated within the family. Transactions take place in a framework of mutual assistance and function according to the unspoken rules of family organization, rather than according to fixed regulations. In principle, intra-family loans are interest-free. While it is possible to deny a loan request from a family member, it is impossible to charge interest. A commercial moneylender in P. turned down the loan request of her daughter as she (the moneylender) was not willing to spend part of her working capital on an interest-free family loan. On the other hand it would not have been possible to charge interest from her daughter.

Most frequently family loans are given among siblings. Inter-generation transfers (from parents to children or the other way round) work sometimes on a loan basis but more often on a gift basis. Family loans are the most favored form of credit in the village as they are cheap and convenient. Among the poorer households these loans do not play an important role and are chiefly spent on urgent expenses. Among the better-off households, family loans are mainly spent on certain consumer goods that otherwise would not have been purchased. In addition, family members help each other with a loan in cases of accident or illness. Cases of loan default are always settled within the family. The consequences for the delinquent debtor range from the forfeit of land to conversion of the loan into a gift.

Group-Based Credit Institutions

Although there is little cooperation above family level and mistrust prevails rather than trust in the village, I identified at least three groups serving the financial needs of their members. All of them seem to fulfil the prerequisites of a functioning group in a game-theory textbook: a small number of players (10-15) with complete information about the other players' past performance, and the game is repeated. The in-group structure imposes the social commitment to behave according to the established principles, and therefore no third-party enforcement is required. But the groups differ as regards provision of funds and social composition.

Joint Liability Groups. At the top of the social ladder we find a joint liability group with 13 members. The BAAC provides loans to members with a maturity of one year. Loan contracts cannot be extended, but after repayment the borrowers normally recontract the loan within a month, the amounts rising from Bt8,000 during the first year by a further Bt3,000-4,000 for each additional year. To tide over the gap between two BAAC loans, group members usually get short-term loans from commercial moneylenders (see below). The group itself and not the BAAC, decides about membership. Thus, as nobody wants to stand surety for a risky borrower, we find the most wealthy households of P. together in the group. The principal reason for entering the group is not the need for capital but the prestige associated with membership, as a sign of wealth and trustworthiness. The BAAC, which is well aware of that process, thus faces a dilemma: on the one hand, its objective of providing loans to the poor is undermined, while on the other hand it is precisely the prestige and social pressure that guarantee regular repayments and make the group work, at least in a narrow financial sense.

Lenshare. The second group engaged in financial activities in P. is a *Lenshare*, one of the Thai ROSCA forms. In contrast to the BAAC group, funds are raised internally in the *Lenshare*. Once a month the approximately twelve members, all of them women, assemble and pay Bt500 each into a common pool. The first round goes to the organizer of the *Lenshare*. During the next rounds the players have to make secret bids by offering surcharges on the monthly contribution, which they are willing to pay until the end of the *Lenshare*. The highest bid wins the pool. A model of the payment schedule for a seven players *Lenshare* has been outlined in Table 1. For example, the winner of round 2. gets the pool containing Bt3,600 with a bid of Bt600, but has to pay Bt4,100 for the whole *Lenshare*. The last player to win the pool receives Bt3,800 having paid only Bt3,500 herself. The *Lenshare* in P. consists of a core of players, including the organizer, that might remain constant over a number of years. All belong to landowning salt-farmer households, i.e. to the higher social echelons of the village. The poor villagers of P. are not admitted. Occasional players join a *Lenshare* from time to time; members of fish farming households hardly ever do. This is indicative of the fact that they are less integrated into the cash economy than the salt farming households. Especially for the latter the *Lenshare* offers useful savings and credit facilities. But we must not overestimate the economic importance of the *Lenshare*, much of its attraction stems from the fact that it includes some gambling features[3]. Gambling is a favorite pastime among all social classes in Thailand. The monthly *Lenshare* meetings in P. are held on the same day that the

Table 1: A Model of the Payment Schedule for a Seven Players Lenshare

Money Paid per Round per Player	*r.1*	*r.2*	*r.3*	*r.4*	*r.5*	*r.6*	*r.7*	*Sum Paid per Len-share*
Organizer	500	500	500	500	500	500	500	3,500
Winner r.2	500	600	600	600	600	600	600	4,100
Winner r.3	500	500	580	580	580	580	580	3,900
Winner r.4	500	500	500	560	560	560	560	3,700
Winner r.5	500	500	500	500	540	540	540	3,620
Winner r.6	500	500	500	500	500	520	520	3,540
Winner r.7	500	500	500	500	500	500	500	3,500
Sum Received by Winner of Round	3,500	3,600	3,680	3,740	3,780	3,800	3,800	

state-run lottery is drawn. Rural *Lenshares* are largely homogeneous, and played by women belonging to one social class. This promotes trust and eases communication among the players, giving the *Lenshare* a socializing function. Its key person is the organizer. Her standing is decisive for the reputation and the composition of the group; she sees to it that the rules are observed, and is ultimately liable for any losses.

Gambling Group. The third group to be mentioned here would not normally be counted as a financial institution by economists and social scientists. It is a group of casual laborers, who work for the salt farmers. During the work-free rainy season, however, they meet day by day to play cards for money. Somehow they always manage to lump together a small amount of money[4] that rotates according to the rules of luck and bad luck. These players are definitely on the very bottom rung of the social ladder of the village. The money involved is negligible, but within their "penny economy" its relative value is large (see Bouman, chapter 7). Although this group is set up mainly for entertainment, it also serves economic needs, as the money circulating in the card game also functions as a small fund from which the players, who are excluded from virtually all sources of credit, can obtain a small loan in case of emergency. In contrast to the *Lenshare*, there are no regular contributions to a common pool, nor is there a sophisticated schedule as to how to administer the fund. Financial matters are handled very informally on a day to day basis and each loan request is discussed at great length.

Commercially-Based Credit Institutions

We now turn to credit transactions where allocation of credit is mainly governed by economic principles. Loans either facilitate the purchase or sale of goods and products -- so-called interlinked transactions -- or, the lending of money is undertaken as an independent source of income.

Interlinked Transactions. In comparison to rice-growing areas the importance of interlinked credit in P. is low. Neither salt nor fish production require a regular purchase of inputs. Salt is sold during the entire salt season and the farmers do not foster regular relations with any one salt trader. Both parties try to profit from the fluctuation in the salt price, which is low during the dry season (salt season) and goes up during the rainy season. Occasionally, traders give interest-free bridging loans towards the end of the income-less rainy season. These loans have to be repaid in salt, allowing the traders to purchase salt at a time when the price is comparatively low.

The most costly procedure in fish production is the *widboadschabbpla* or "fish harvest". Money is required to buy diesel for the pumps and to feed the work-party. Work-parties are not only an economic, but also a social event, and the amount of money spent on food, drinks and music is as much as one would have to pay for hired labor (Bt1,500-2,000 per work-party). In contrast to the salt farmers, the fish farmers have long established relations with fish traders. About two weeks before the *widboadschabbpla*, the farmers usually receive a loan from their trader to finance the forthcoming expenses. In return the trader may first resell the fish before paying out to the farmer. In the fish farmer/trader relationship, therefore, credit is mutually employed to ease payments of extraordinarily high sums of money.

The small shop in P. is probably the most important credit agency for the poor of the village, who can chalk up urgently needed items for daily consumption, without the female shop owner making any extra profit.

3. The word *Lenshare* is composed of "Len" (which means: to play) and the English "share".
4. In fact, I never found out where the money always came from. It is one of the mysteries a researcher is confronted with from time to time.

Rather chalking up is a necessary evil to keep the shop going, while she herself becomes indebted to her wholesale suppliers from time to time. The better-off in the village are well able to pay these items in cash, but durables, like TV-sets and especially cars, are normally bought in installments from traders in the market place or from shops in the nearby town. A mark up of roughly 25 percent is charged on these payments in installments.

Moneylending. The credit institutions described so far make up a substantial part of informal finance all over Thailand. The impact of the economic boom on the quality and quantity of these transactions is still moderate. But besides these institutions, we find a moneylending business in P. whose emergence and peculiarities can only be explained against the background of the recent economic changes described above.

The villagers in P. have access to the services of four moneylenders. Two semi-professional lenders, i.e. lenders who obtain an additional income from moneylending, live in -- or close to -- the village. Two professional lenders, i.e. lenders who obtain the major part of their income from moneylending, live in the nearby market place. All four moneylenders are women. Only one of them runs a long established business, the others started operations within the last ten years. The rapid increase in land value combined with the decline of the paddy price led to massive land sales in many areas bordering on Greater Bangkok. But due to the stable prices for salt and fish only a minority in P. sold land, thereby obtaining the working capital to run a moneylender business. Their funds are commonly deposited with one of the commercial banks. These new lenders satisfy the growing credit demand of the better-off landowning households. Increasingly, the latter want to realize a part of the wealth resulting from the higher land value, but without actually selling the land. Loans are spent on consumer goods and, above all, on the upgrading of their houses. As a result, the social gap between the landless and the landowners is becoming much more conspicuous than in former times. These moneylender loans make up less than 25 percent of all loan contracts but comprise about 80 percent of the total money lent out in P. and well exceed the average size of informal loans throughout Thailand. Recent surveys in Thailand (Siamwalla 1990; Onchan 1992) suggest that the average informal loan is Bt6,360 and the average portfolio of a local lender is Bt36,000. In P., by contrast, the loan portfolio of the semi-professional lenders is close to Bt100,000 each with individual loans of Bt5,000 and Bt20,000. The loan portfolio of the two professional lenders is Bt700,000 and Bt2-3 million respectively and individual loans amount to between Bt50,000 and Bt300,000!

While the moneylender business is commonly labelled as informal, the lenders in P. operate on a highly formalized level. Each loan is set down in written contracts. Maturity is limited to two years. In cases of non repayment, one year extensions on the principal are readily granted and only the outstanding interest has to be paid on a monthly basis. By extending the contracts the moneylenders forestall loan defaults. All four lenders charge 3 percent interest per month, but for loans exceeding Bt100,000 the interest rate will normally be reduced to 2 percent. The interest has to be paid monthly and the rate is never mentioned in the loan contracts. It is commonly assumed that informal loans in Thailand are mainly secured by personal relations and trust, rather than by collateral (Onchan 1992: 111). In P. however, the moneylenders allocate credit against collateral only. The semi-professional lenders accept a variety of possible securities: land, gold or a guarantor, while the professional lenders only accept land as collateral. The fact that borrowers and lenders are personally acquainted promotes confidence and facilitates the transaction. But, as all moneylender loans become secured by collateral, borrowers are no longer limited to the services of only one lender whom they must know for many years and with whom they should be linked in various ways before getting credit. Moneylenders in P. set up their services for commercial reasons and pursue what Bailey (1971) would describe as a modern, single-interest business. They exchange information about their customers and pass on loan applicants if one of them runs short of funds. It is noteworthy that most of their clients would have access to commercial bank loans as well. But the villagers prefer the convenience of the moneylenders. It takes only a few days to process a loan, moneylenders are much more flexible in loan extensions or rescheduling, and the transaction costs of moneylender loans are comparatively low. For their part, bank officers commonly do not yet consider the better-off farmers creditworthy and, as a result, have not yet extended the commercial banks' business into these rural areas.

In short, a new viable informal credit institution has been established in P. in recent years. The rise in the value of land caused a new demand for consumption loans on the part of the landowners. This demand is best satisfied by the local moneylenders, who themselves started their business with land sales as a reaction to the increased land value. Moneylending provides those women, who are unable to cultivate the land themselves, with a better income than renting out the land, and it is by far less troublesome than hiring labor which is scarce in the region. Moreover, the stable economic environment and collateral requirement preclude thorough monitoring and screening of customers, and the lenders do not need specialized skills. The newcomers in the moneylending business copied the routines of the longer established lenders in the neighborhood. Moneylender interest rates in the region have been astonishingly stable for a long period and have not even responded to the marked fluctuations in the rate of inflation.

Findings

The results of the survey in P. give an insight into the performance and development of the financial landscape in a region that is characterized by radical economic changes. In the village we find a number of different informal credit institutions, while formal credit -- apart from the BAAC joint liability group -- has not gained a foothold despite the rapid economic development in the region. Credit allocation must be understood as part of a complex set of economic and social relations. Consequently the respective functions of a loan vary significantly, are seldom interchangeable and cannot be explained satisfactorily by the economic need of a debtor. Functions range from the enhancement of prestige (joint liability group) via the facilitating of payments, to the bridging-over of periods of no income. In the majority of cases indebtedness does not occur as a result of economic hardship, and is more a sign of wealth than of poverty. While the informal credit sector is commonly believed to serve the credit needs of the poor, in P. the bulk of credit is allocated to the better-off households and the poor are excluded from virtually all sources of informal and formal credit.

Surprisingly, informal credit has not declined in the course of economic development as expected by many scholars. Instead, a new viable informal credit institution has emerged as a reaction to the rise in land prices. The moneylender business in P. should be perceived as an institution at the interface between the (traditional) peasant economy and the (modern) market economy. On the one hand, it operates according to commercial principles; the collateral requirement and the informational network of the lenders result in an efficient allocation of funds at moderate costs. On the other hand, moneylending is still backed by personal acquaintance and the determination of interest rate is based on tradition rather than calculated economically. Nevertheless, the moneylenders succeed much better in serving the credit needs of the farmers than the commercial banks do.

With regard to “economic strategies” a further point should be emphasized. For many years the provision of credit has been an important tool with which to promote productive investment by farmers and craftsmen. These development strategies have been based on the assumption that the lack of the availability of capital is the major obstacle to investment. The findings in P. demonstrate that farmers do not necessarily behave in a profit-maximizing fashion. Both in salt extraction and fish farming, outputs might well be increased by introducing more capital-intensive methods. In particular salt extraction in its traditional form is limited to merely a part of the available land due the shortage of labor. Yet the farmers still prefer to spend their loans on consumer items.

Of course, one should not generalize from findings as they cannot be representative for the country. But they show that conventional theoretical concepts of the causes and manifestations of indebtedness are often too one-sided. Furthermore, they are evidence of the variety, adaptive capacity and resilience of the informal financial sector.

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18

A Changing Financial Landscape in India: Macro-Level and Micro-Level Perspectives

J. Howard M. Jones

With the entry and expansion of rural formal finance in India significant changes of rural financial landscapes are reported. First, the physical features of these landscapes have been radically changed with the establishment of cooperatives, rural and semi-urban branches of commercial banks, land development banks and Regional Rural Banks: in total, just over 146,000 primary offices by 1986 (Gadgil 1986: 301). Second, policies directed through these formal constituents of rural financial landscapes have combined both development and welfare objectives, by means of government directives concerning bank location and loan portfolios, and a series of poverty alleviation programs with subsidized, activity specific and target group specific credit as the main instrument (Copestake 1987; Wiggins and Rajendran 1987). Third, dramatic changes have been reported in the relative shares and importance of formal and informal financial intermediaries. Using data from three Reserve Bank of India (RBI) decennial surveys, for 1961-62, 1971-72 and 1981-82, Gadgil (1986) and more recently Pradhan and Dinakar (1990), note on an all-India basis, a considerable rise in the share of formal credit in total cash debt of farmer households (18 percent in 1961 to 63 percent in 1981) and a consequent, very substantial, decrease in the share of informal credit (70 percent in 1961 to 23 percent in 1981). A residual category "other", including insurance and provident funds, accounts for the balance in each of the reference periods.

Although inter-state variations in the reported shift from informal to formal sector financial provision are acknowledged, the results of the three surveys lead Gadgil (1986: 282) to note that, "The professional moneylender has virtually vanished from the villages and the role of informal credit has diminished considerably" and similarly, Pradhan and Dinakar (1990: 220) to assert "the progressive decline in all categories of non-institutional agencies at the all-India, as well as state levels." Furthermore, Iqbal (1988) reports a decline in informal interest rates for those villages in India where rural banks have been established.

Pradhan and Dinakar recognize methodological problems in drawing conclusions from the three surveys: measurements in terms of outstanding debt overestimate the share of formal finance while under-estimating the share of informal finance, and all data for the three surveys are based on respondent recall without reference to institutional records. Lipton (1976) notes that high shares reported for institutional finance are not necessarily equated with high shares of participating farmers, given unequal land distribution and the social dynamics of rural credit in village-India. In a similar vein, Bardhan and Rudra (1978) note how large-scale credit surveys often fail to capture the intricacies of interlinked credit relationships with labor and landlease markets. More generally, Harriss (1989), by comparing the results of macro (census and survey investigations) and micro (anthropological studies or small-scale surveys) research in Tamil Nadu, demonstrates the problems of "ascertaining, aggregating and interpreting" through large-scale surveys, fundamental facts about agrarian change, given the complexity of labor force structure and economy in rural India.

Collecting data on rural financial landscapes at the micro-level poses particular problems. Although anthropological investigations emphasize the wider economy and society in which credit relations are "embedded" (Caplan 1972), such micro-level research, usually relies on clients for establishing basic facts concerning these landscapes, although, as Darling pointed out in 1925, these clients are always anxious to throw "the purdah" over their debts. Even so, contemporaneous micro-level studies, like those of Djurfeldt and Lindberg (1975) and Sivakumar (1978) in Tamil Nadu, Platteau (1980) in Kerala, and Michie (1978) in Rajasthan, report much higher levels of informal credit compared to State level aggregate data for the periods in question. The paucity of basic facts derived from informal lenders themselves is particularly apparent with respect to unlicensed lenders. Bouman (1989) doing research in Maharashtra noted the problem of access to unregistered moneylenders, and Michie (1978) in his survey of village moneylenders in Rajasthan, found it necessary to investigate their position in the agrarian economy by reference to a hypothetical case-study of lending practices.

The purpose of this paper is twofold. First, to provide an example of a micro-level financial landscape in India, whereby the effects of entry and expansion of village bank finance upon pre-existing informal financial arrangements are assessed, by data collected from the lenders (both informal and formal) themselves. Second, to consider the implications of these data for macro-level surveys of financial landscapes.

The Setting

To illustrate the changing financial landscape at the micro-level, data are presented from the records of informal and formal lenders operating from a village in South Rajasthan[1]. The principal comparison is with respect to the lending activities of an individual unlicensed lender (a shopkeeper) and the village bank. The lending records of the informal lender are examined with respect to just before (1982-83) and six years after (1988-89) the bank was established in the village. The lending records of both these financial intermediaries are then examined over the course of a full year 1988-89; the role of informal mutual finance is also considered. But first, a brief outline of the local setting.

The village, referred to as Chandrapur in this paper, is located in Dungarpur District, a predominantly tribal area in South Rajasthan. Chandrapur itself consists of a largely caste Hindu and Jain[2] population living in the nucleated part of the village (where the bazaar area is located) and a Bhil population living in the hinterland: in all, a total population of just over 1,000 persons and 200 households in 1989. Land holdings are small (an average of just 0.07 ha of irrigated land and 0.57 ha of unirrigated land for Chandrapur households in the 1981 Census) and fragmented, and households in the area derive a livelihood from a mixture of agricultural and non-agricultural activities. For Hindu households, the non-agricultural activities are largely caste-based. Jain households dominate the commercial and financial services in the village. Migration to Gujarat and Bombay provides intermittent employment in the construction and service sectors. In addition, from the mid-1970s, a number of mainly Blacksmith and Tailor caste men from Chandrapur had secured employment in the Middle East.

Although in the 1970s a few households in Chandrapur secured some bank finance from the district town some 25 kilometers away, up to the end of 1983, the only regular sources of credit available to households, were village-based informal financial intermediaries. The major sources of commercial informal credit were Jain shopkeepers, who in 1983, ran 20 of the 28 retail shops in the village. In December 1983, a commercial bank branch was established in Chandrapur.

According to RBI data, the penetration of commercial banks in the rural areas of Rajasthan has brought about a fundamental shift of the financial landscape of this State. Whereas the 1961 survey reported no outstanding cash debts of households to commercial banks, by 1981 just over 25 percent of outstanding cash debts of cultivator households were commercial banks (Pradhan and Dinakar 1990: 199). Conversely, whereas in 1961 the shares of outstanding cash debt with agriculturalist moneylenders, professional moneylenders and traders were 30.1 percent, 36.5 percent and 15 percent, by 1981 the shares of these debts had declined to 9 percent, 15 percent and 4.5 percent respectively. The total share of these informal agents had declined from 82 percent to 28 percent in 20 years (Pradhan and Dinakar 1990: 199). We now turn to Chandrapur to see if a similar process is evident at the micro-level.

Pawnbroking Credit 1982-83 and 1988-89

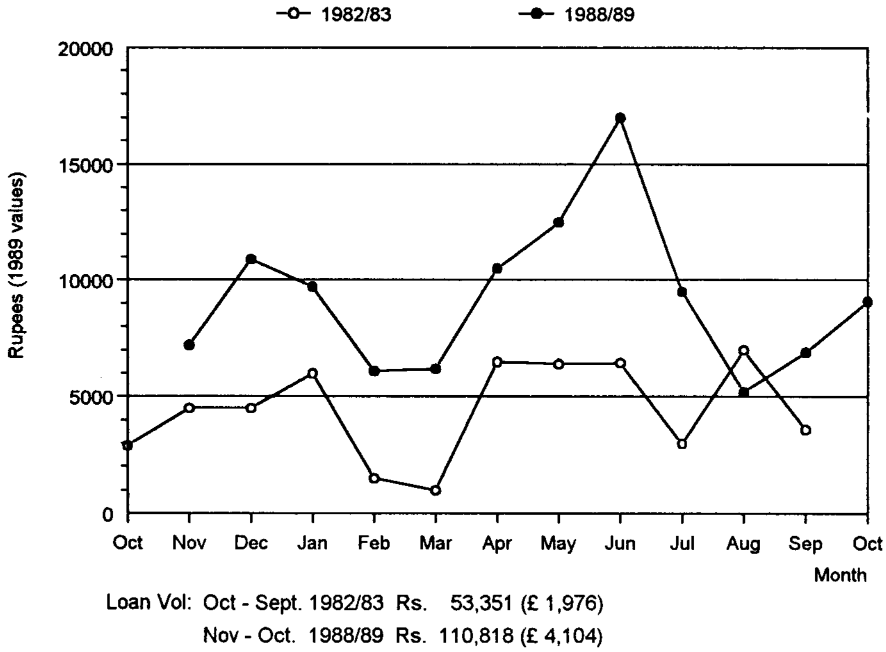
To investigate the effect of the Chandrapur bank on the informal credit sources, we first compare the 1982-83 and 1988-89 pawnbroking records of a Jain shopkeeper in the village referred to as B. Jain[3]. Pawnbroking credit advanced from his general goods store for these two years, is shown in Figure 1.

First we can note, that six years after the establishment of the village bank, the flow of yearly loan volume had actually increased from Rs.53,351 (£1,976) during 1982-83 to Rs.110,818 (£4,104) during 1988-89: an increase of just over 100 percent.[4]

Second, in contrast to Iqbal's (1988) findings, the establishment and expansion of formal bank services in the village has not led to any changes in the terms and conditions of the pawnbroking loans after 1983. Interest on these loans in 1988-89 was, as in 1982-83, 3 percent a month on the amount recorded in the account books. Furthermore, during both reference years, clients received a cash loan 10 percent less than the recorded figure.

1. Empirical data in this paper are based on a three-months field visit in 1983 and a two-months field visit in 1989-90. A brief visit was also made to the village in January 1992.
2. A religious, trading and merchant community, famous throughout India for their business acumen. See Carrithers and Humphrey (1991), and Jones (1991).
3. The writer lived with B. Jain's household during the 1983 and 1988-89 field visits. Information normally collected by B. Jain for each of his pawnbroking loans was made available to the researcher: name and village of client, type and weight of jewelry deposited, amount and date of money advanced. For each pawnbroking loan advanced during 1988-89, B. Jain agreed to note down and make available two additional pieces of information: loan purpose and date of repayment.
4. 1989 values and exchange rate (Rs.27 = £1 Sterling).

Figure 1: B. Jain's Pawnbroking Credit 1982-83 and 1988-89 by Loan Volume (Rs)



Third, the seasonality of the pawnbroking loan provision is strikingly similar for both reference years, a seasonality that is largely determined by client households' cultivation, domestic and ceremonial needs at particular points in the year. These needs remain largely unmet by the village bank.

Fourth, an increase of pawnbroking loans was also evident: during 1982-83 a total of 290 loans were advanced and this number had increased to 335 during 1988-89.

Fifth, there had also been an increase in the number of pawnbroking businesses over the same period of time: in 1982-83 there were nine Jain shopkeepers and a Jain widow running pawnbroking businesses from Chandrapur, plus five other ones run by non-Jains in the village. By 1989, although the Jain widow had died in the intervening period, a total of 19 Jain shopkeepers operated pawnbroking businesses in Chandrapur. This increase was mainly due to the division of a large joint family of 10 Jain brothers now running a greater number of individual retail shops. The five non-Jain pawnbrokers were also still operating in 1988-89. Thus, far from disappearing from the financial landscape, the number of pawnbroking shops operating in Chandrapur had actually increased from 15 in 1983 to a total of 24 in 1989.

Pawnbroking Credit and Bank Credit 1988-89

In the RBI macro-level surveys, relative shares of informal and formal credit are measured in terms of stock of outstanding debt. However, examination of B. Jain's pawnbroking records, in conjunction with the bank's lending records for 1988-89, shows shares of loan provision differing radically according to criterion of either loan volume or number of loans. In addition, analysis of loan provision by size, seasonality, purposes, client groups and repayment rates, points to reasons for the continuing significance of pawnbroking credit, in the face of locally available bank finance.

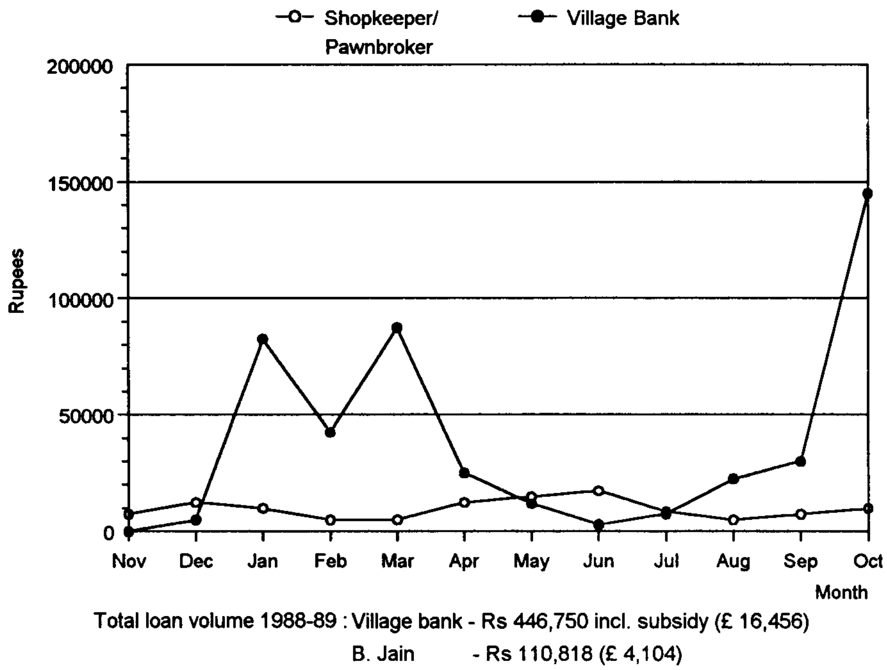
Loan Volume and Number of Loans

Together, the bank and B. Jain advanced a total of Rs.557,568 over 1988-89. From Figure 2 it can be seen that 80 percent (Rs.446,750) of loan volume was advanced by the bank and 20 percent (Rs.110,818) advanced by the shopkeeper.

However, in terms of number of loans, a quite different picture of relative shares emerges. Figure 3 shows that only 90 of the 425 loans advanced during 1988-89 were advanced by the bank while the remaining 335 loans were advanced by the shopkeeper. Thus, a comparison purely in terms of loan volume, as common in macro-level surveys, would seriously underestimate the significance of B. Jain's pawnbroking credit in relation to local bank lending.

Even in terms of loan volume, estimates of relative shares for B. Jain need to be qualified, as this shopkeeper also advanced goods on credit in addition to pawnbroking loans. In September 1983, the former had an

Figure 2: Bank Credit and B. Jain's Pawnbroking Credit 1988-89 by Loan Volume (Rs)



outstanding value of Rs.14,766[5] spread across 59 client accounts compared to Rs.83,807 for 350 pawnbroking loans. It was not possible to record flow of credit in goods for 1988-89, but clearly the relative share of B. Jain's loan volume would be higher than that indicated in Figure 2 if this second type of credit could also have been taken into account.

For Chandrapur, as a whole, a tentative estimate of pawnbroking loan volume is made by multiplying Rs.110,818 (B. Jain's loan volume) by the proportions of loan volume indicated by this shopkeeper for the other 23 lenders in the village. Adding the figure to his own loan volume produces a total of Rs.2,282,850 for all 24 pawnbrokers in the village: five times the loan volume advanced by the bank during 1988-89.

A similar extrapolation from the 335 loans advanced by B. Jain, results in a total of 6,799 loans for all 24 pawnbroking businesses: 75 times the number of loans advanced by the bank in 1988-89, six years after it was established.

Size of Loans

During 1988-89 the mean value of loans by the bank was Rs.4,963, 15 times that of loans within the pawnbroking business (Rs.331). The maximum and minimum value of loans also reflect differences in scale of lending between the two credit sources. The maximum value of loans advanced by the bank was Rs.14,000, three and a half times that of loans within the pawnbroking business (Rs.4,000). Similarly, the minimum size of bank loan during the year was Rs.500, 18 times that for the pawnbroking loans (Rs.27).

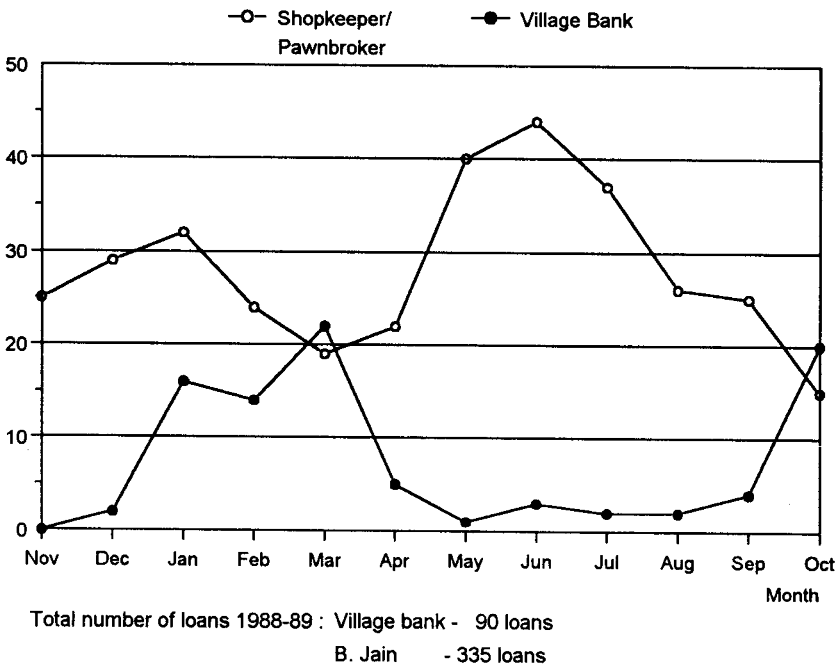
In contrast to the bank, not only does the shopkeeper advance a multitude of "mini-loans" (Bouman 1989) but individuals may secure multiple loans during the year. Although during 1988-89 the majority of clients (68 percent) took one pawnbroking loan from B. Jain, the remaining clients had each taken between two and six loans over this period.

Seasonality of Loans

Stock of debt measures, as used in the macro-level surveys, also conceal important differences in the timing of informal and formal loan provision. Whereas the shopkeeper never advanced fewer than 15 pawnbroking loans a month, the bank advanced no loans in one month (November), advanced just five loans or less for a further seven months, and in only two months during 1988-89 (March and October) advanced marginally more loans than the single pawnbroking business (see Figure 3). Furthermore, it is clear that the seasonality of loan provision is almost the opposite for these two financial agents. The bank's maximum loan provision occurred

5. 1983 prices and exchange rate (Rs.15.2 = £1.Sterling).

Figure 3: Bank Credit and B. Jain's Pawnbroking Credit 1988-1989 by Number of Loans



during March and October (23 percent and 22 percent of loans), the very two months that correspond with minimum loan provision (6 percent and 4 percent of loans) for the pawnbroking business. Conversely, the maximum number of loans from the pawnbroking business, were advanced in the months of May (12 percent), June (13 percent) and July (11 percent), the three months with very few loans (1 percent, 3 percent and 2 percent) advanced by the village bank. The seasonal differences are largely accounted for by differential loan purposes and client groups.

Loan Purposes

In RBI surveys quoted by Pradhan and Dinakar (1990: 204) five categories of loan purpose are identified and their relative shares measured by proportions of outstanding loan volume. For Rajasthan in 1981 these are as follows: capital expenditure in farm business (36.2 percent), current expenditure in farm business (12.0 percent), non-farm business expenditure (12.6 percent), household expenditure (32.0 percent) and "other" (8.1 percent). However, the use of such broad categories of loan purpose mask significant differences between informal and formal credit provision, and the use of loan volume alone to measure relative importance of loan purposes can underestimate the significance of particular credit needs.

With respect to B. Jain's pawnbroking loans, Table 1 shows eight categories of loan purpose, with 36 individual loan purposes. The percentages refer to volume and number of loans during 1988-89.

Although the eight loan categories in Table 1 are broadly similar to those used in the macro-level surveys, it is only the identification of individual loan purposes from the lending records that reveals the full range of credit needs met by the pawnbroking business. Variations in the relative importance of loan purposes, according to loan volume or number of loan measures, are also evident from Table 1. For example, in terms of loan volume, pawnbroking loans to buy food account for just 10 percent of loan provision, but in terms of number of loans this loan purpose accounts for as many as one in five loans over the year.

Whereas the bank loans catered to a limited range of officially sanctioned loan purposes, the shopkeeper willingly advanced pawnbroking loans for an extensive range of needs. A very high proportion of the 1988-89 bank loans (73 percent of loan volume and 70 percent of number of loans) were secured through the Integrated Rural Development Programme (IRDP), whereas the shopkeeper advanced credit for a large number of ceremonial, domestic consumption and productive purposes.

Compared to the bank's IRDP loans, a much lower volume of pawnbroking loans (27.3 percent) went to productive purposes: agriculture loans, loans to finance informal lending and business loans. However, this figure needs qualification.

First, following Ghate's (1988) classification, a further 16.3 percent of pawnbroking loan volume was taken for productive consumption purposes: house construction, education expenses, loans to secure employment and loans to finance migration. Thus, productive loans and loans for productive consumption purposes together account for 43.6 percent of loan volume, and 37 percent of number of loans advanced in 1988-89.

Second, although proportions of loan volume for productive purposes were generally lower for the shopkeeper, analysis of individual loan purposes indicates more positive features compared to the bank. This is shown by reference to loans for agricultural purposes. In fact, B. Jain advanced a much higher proportion of loan volume for agricultural purposes (19.1 percent) compared to the bank (8.7 percent). Moreover, in absolute terms this single shopkeeper advanced four times the number of loans for agricultural purposes (54 loans) compared to the bank (13 loans). Also, whereas the bank's agricultural loans were all IRDP livestock loans, the shopkeeper advanced pawnbroking credit for an extensive range of agricultural fixed capital (six loans) and seasonal needs (eight loans). In addition, whereas 11 of the bank's 13 agricultural loans were advanced in March, the shopkeeper supplied loans for agricultural purposes, precisely when cultivators needed them, for as many as 10 months in the year.

Borrower Groups

Pradhan and Dinakar (1990), quoting RBI survey data, differentiate borrowers in terms of asset group: the smaller the cultivator, the greater the dependence on non-institutional agencies. However, such categories are suspect given the complex combinations of agricultural and non-agricultural employment patterns (Harriss 1989) and they also conceal significant group relations at the local level (Lipton 1976). With the identification of each borrower in the bank's and the shopkeeper's lending records these relations become apparent.

The bank had a much higher concentration of loan provision within the village compared to the pawnbroking business. Over half (54 percent) of loan volume and 43 percent of loans went to clients in Chandrapur, even though the bank's official area of operation included 17 villages under the service area approach to rural

Table 1: B. Jain's Pawnbroking Credit 1988-89: Categories of Loan Purpose and Individual Loan Purposes by Percentage of Loan Volume (% Vol) and Percentage of Number of Loans (% No)

	% Vol	*% No*
1. Life-cycle	22.5	17.0
a. birth	0.6	0.9
b. haircutting ceremony	0.5	0.3
c. marriage	19.5	12.8
d. divorce	0.2	0.3
e. death	1.6	2.1
2. Household (domestic)	31.1	41.8
a. house construction	8.4	3.6
b. food	9.9	21.2
c. guests	0.7	2.4
d. medical	9.2	10.1
e. education	1.0	1.8
f. employment	1.2	1.2
g. consumer goods	0.6	1.5
3. Finance	12.8	6.9
a. pay back informal credit	4.7	3.0
b. finance informal lending	4.2	2.1
c. pay back formal credit	3.9	1.8
4. Business	4.0	2.4
a. shop goods	3.6	1.5
b. raw materials	0.4	0.9
5. Travel	6.0	11.0
a. local	0.3	1.2
b. non-local	5.7	9.8
6. Agriculture	19.1	16.1
(i) Seasonal	4.2	6.9
a. land tax	0.8	2.1
b. level fields	1.0	0.6
c. rent pump	0.1	0.3
d. veterinary	0.2	0.6
e. buy seeds	1.1	1.8
f. transplant rice	0.5	0.9
g. harvest maize	0.1	0.3
h. tractor license	0.4	0.3
(ii) Fixed capital	14.9	9.2
i. buy land	2.0	1.5
j. boundary walls	0.4	0.3
k. build well	1.6	1.2
l. buy pump	1.4	0.3
m. buy bullock	9.3	5.7
n. buy cow	0.1	0.3
7. Leisure	0.5	2.1
a. fairs	0.4	1.5
b. cinema	0.1	0.6
8. Other		
a. litigation	4.0	2.7

banking[6]. In contrast, 33 percent of loan volume and just 23 percent of number of pawnbroking loans were advanced by B. Jain to clients within the village. A much higher proportion of number of loans (75 percent) and loan volume (64 percent) were advanced to Bhil clients in the tribal settlements compared to the village bank (56 percent and 45 percent respectively), even though such Scheduled Tribe clients are a specific target group for the banking sector and form over 90 percent of the population in the bank's official area of operation. The greater proportion of pawnbroking loan provision precisely to formal sector target groups is also evident with respect to Scheduled Caste clients. Whereas 18 percent of loan volume and 15 percent of loans went to clients within this category, no bank loans were advanced to Scheduled Caste clients during 1988-89.

Conversely, the position with respect to Jain clients in the village is quite the opposite. Whereas B. Jain advanced no pawnbroking loans to Jains during 1988-89 (to take such a loan would involve loss of prestige with fellow Jains), 28 percent of loan volume and 17 percent of loans advanced by the bank went to clients from this trading and commercial community. Within Chandrapur, 52 percent of loan volume went to Jain clients. Moreover in December 1989, 14 of the 19 Jain shopkeepers with pawnbroking businesses in the village held outstanding loans with the village bank.

Loan Repayment

Over half (52 percent) of the bank's 442 outstanding loan accounts were overdue in December 1989, of which over 30 percent were overdue by more than three years. This finding is consistent with other reports of poor repayment records for rural banks in India (Bouman 1989). The repayment position with respect to the bank's agricultural loans was particularly acute, with 71 percent of overdues being overdue by more than three years. This is in great contrast to repayment rates within B. Jain's pawnbroking business, where nearly 70 percent of loans and 63 percent of total loan volume advanced during 1988-89 were repaid in full. Subsequent information obtained in January 1992 confirmed these trends. At that time, of the 335 pawnbroking loans, as many as 289 loans had been repaid in full, and the jewelry deposited with respect to just eight of the remaining 46 loans had been sold by the shopkeeper. With reference to the 63 IRDP loans advanced by the bank over 1988-89, by January 1992, just 20 of these loans had been repaid in full.

Multiple Loan Provision

Table 2 shows 14 loans, advanced by B. Jain during 1988-89, to five siblings belonging to the Jogi caste in Chandrapur against the security of silver (12 loans) or gold (two loans). The Jogis are officially included in the Scheduled Caste Lists, who in the early census records were variously classified as "miscellaneous vagrants" and "religious mendicants". They have particularly small land areas in the village and rely to a large extent on income earned from migration to Gujarat and Bombay.

Although the Jogis, after the Bhils and the Jains, are the third largest group in Chandrapur, they received no bank loans during the year and in December 1989 accounted for just seven of the 86 outstanding bank loans advanced to clients in Chandrapur since 1983. In contrast to thebank, not only did B. Jain advance a total of 52 pawnbroking loans to this disadvantaged group, but just over half of the Jogi clients took more than one loan during the year.

Four of the five death loans were repaid within very short time periods. All four marriage loans had not been repaid by August 1991, and were then between 28 and 31 months old. The rather larger size of these loans may partly explain the difficulties in repaying them. Furthermore, the fact that the marriage expenses were being incurred at about the same time as the death expenses for the father, made it even more difficult to repay them.

It is clear that a series of overlapping life-cycle events account for the majority of loans advanced to the five siblings. The loans connected with the death, the loan for the Holi (Spring festival) celebrations after the birth of a child, and the marriage loans together account for 72 percent of all money advanced. Not only was the shopkeeper willing to advance loans for these largely ceremonial purposes, but the loans were advanced immediately, were of a size the clients required, were provided at the time clients needed and were secured through acceptable collateral. Moreover, the case of the two Jogi sisters in Table 2 points to an important difference in loan availability for women clients. Both sisters are married and resident outside the village. Nonetheless, on

6. Introduced in India from April 1988, whereby branch managers are responsible for identifying potential credit support to schemes suited to the local area. See Jalan (1990).
7. A diverse group of indigenous peoples protected under Article 46 of the Indian Constitution. See Mandelbaum (1970) for social, political, economic, religious and psychological distinctions between tribe and caste.
8. Castes traditionally regarded as untouchable due to the polluting nature of their occupation and, like the tribal peoples, now protected under Article 46 of the Indian Constitution. See Parry (1979).

Table 2: B. Jain Pawnbroking Credit 1988-89: Multiple Loan Provision Within Jogi Sibling Group

Borrower	*Date of Loan*	*Amount (Rs)*	*Loan Purpose*	*Months to Repay*
Brother A	01.12.88	900	Payback informal credit	4
	16.12.88	100	Local travel	2
	24.02.89	140	Death father: insurance	1
	14.03.89	167	Birth: Holi: celebrations	2
	20.07.89	200	Death: wants father's job	2
Brother B	16.03.89	200	Travel to Bombay	NPB[a](29 months)
	20.04.89	220	Brother's (C) marriage	NPB[a](28 months)
Brother C	08.01.89	200	Death: father	1
	12.01.89	200	Death feast father	1
	20.01.89	500	Marriage (own)	NPB[a](31 months)
	01.02.89	110	Death father: insurance	NPB[a](30 months)
Sister D	18.11.88	600	Food: father ill	2
	26.01.89	500	Brother's (C) marriage	NPB[a](31 months)
Sister E	21.01.89	250	Brother's (C) marriage	NPB[a](31 months)

[a] Not paid back by August 1991.

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visits to Chandrapur, in contrast to the village bank, they are able to take pawnbroking loans from the shopkeeper to fulfil continuing family obligations.

Mutual Finance

Another category of informal finance, mutual finance, not specifically allowed for in the macro-level RBI data quoted by Pradhan and Dinakar (1990) and Gadgil (1986), also shows signs of expansion rather than contraction since the establishment of a bank in this village. In addition, a micro-level analysis of group membership and lending records, points to significant differences, not just between mutual finance and specialist informal finance such as pawnbroking credit, but also between different mutual finance groups in the same locality.

Between 1982 and 1991 eight savings and credit groups were established in Chandrapur (see Table 3). By 1991 their combined, but sometimes overlapping membership, totalled 126 persons (125 men and just one woman), and although not all members resided in the village, 50 of the 200 village households participated in this kind of informal finance. Although the persons who have formed these groups refer to them as "banks", they have not developed banking functions as such, and loans are advanced solely within the groups themselves. All eight groups are indigenous organizations and correspond to Bouman's ASCRA model (see chapter 22) rather than the ROSCA model.

Membership of the groups is based largely on modern profession or traditional community. The Government Employees' bank and the School Staff bank, are based on modern professional occupation. Membership of the Mahavira bank and the Panchal bank, are based on traditional community, the Jains and the Blacksmith Caste respectively.

Furthermore, membership of three more groups, the Superstar bank, the Mitra (Friends) bank, and the V.I.P. (Very Important Persons) bank are largely based on community bonds, with the majority of members being Jains. The Hanumanji bank is a savings and credit group originally established by a number of children in the village.

Overall, 71 percent of members of the eight groups are resident in the nucleated part of Chandrapur. This spatial concentration of membership within Chandrapur is reflected in the low participation in these groups by Bhil cultivators living in surrounding tribal settlements. Just 8 percent of all members are Bhils. This is in contrast to both the pawnbroking network and the village bank, where 75 percent and 56 percent of number of loans were respectively advanced to clients from the Bhil tribe during 1988-89. This is also largely the case with respect to members who are Scheduled Caste.

Conversely, the situation with respect to the Jain community in the village is quite different. Thirty-four percent of members in the eight savings and credit groups are Jains, making this the most highly represented community in the village with respect to the mutual finance groups. Twenty-two of the 34 Jain households in the village participate in the savings and credit groups and 13 of the 19 Jain shopkeepers running pawnbroking businesses belong to such groups. Moreover, just over half of these 13 lenders are members of more than one mutual finance group in the village.

Table 3: Savings and Credit Groups: Year Established, Number of Members and Monthly Contributions in January 1990

Name of Group	*Year established*	*Number of Members*	*Monthly contributions (Rs)*
1. Government Employees' bank	1982	30	10
2. Panchal bank	1986	21	10
3. Superstar bank	1986	10	50
4. School Staff bank	1987	17	20
5. Hanumanji bank	1987	8	10
6. Mahavira bank	1988	14	25
7. Mitra bank	1989	12	100
8. V.I.P. bank[a]	1991	14	100

[a] Number of members and monthly contribution for the V.I.P. bank refer to January 1992.

All eight groups charge a monthly interest rate of 1 percent on loans, lower than the 3 percent monthly charge for pawnbroking loans and a little bit higher than the 10 percent annual charge for IRDP bank loans.

A conservative estimate of loan volume for the six groups in the village for 1988-89 gives a total loan volume figure of Rs.118,566 (£4,391) similar to the loan volume advanced by the single pawnbroking network, and nearly a quarter of the loan volume advanced by the village bank over the reference year.

More significantly, it was clear that by 1992 some mutual finance groups, through expansion of their capital base, were now advancing loans of a much higher value than those reported for 1988-89. For instance, the Mitra bank in 1989 reported a maximum loan size of Rs.1,500. However, by 1992 our B. Jain, a member of the Mitra bank, had recently taken a loan of Rs.13,500 and the cashier in the village bank, also a member of this group, had recently taken two loans, of Rs.18,000 and Rs.20,000 respectively. Thus, it appears that by 1992, yearly loan volume figures for some of the savings and credit groups in the village, particularly those with a high proportion of Jain members, were beginning to rival that of B. Jain's pawnbroking business and in aggregate may now exceed both yearly loan volume and number of loans advanced by the village bank.

In 1988-89, loans advanced within the savings and credit groups (with the exception of the very small loans advanced within the Hanumanji bank) fell between the mean value of loans advanced within the pawnbroking network (Rs.331) and the mean value of loans advanced by the village bank (Rs.4,967). Through multiple membership within and between the different savings and credit groups in the village, individual households could obtain greater access to mutual finance and thus secure larger amounts of loan capital. Moreover, the build up of the capital base of the groups has enabled ever larger loans to be made.

Conclusion

In this paper, a financial landscape in India has been viewed from the hedge rather than from the hill. Macro-level surveys are a view from the hill, where "Landscapes, for all their intricate, living detail, are forever being squeezed down to ... generalities and abstractions" (Mabey 1993: 43). Prevalence of informal and formal credit is reduced to measures of stock of outstanding debt, a measure that undervalues the significance of informal credit and conceals major differences in the seasonality and timing of informal and formal loan provision. Client households are reduced to broad categories of cultivating households, obscuring the complexity of household income sources and credit needs in the rural economy, and masking significant group relations at the local level. Loan purposes are reduced to broad categories of productive and consumption needs, categories which themselves include a very diverse set of individual and sometimes overlapping loan purposes. Moreover, loan purposes can be marginalized by measurement in terms of stock of debt rather than number of loans. It is a landscape drawn by structured interviews with relative strangers (Bulmer 1993), on a topic the clients least want to give information about and where main operators in the landscape, financial agents themselves, are not directly involved.

The micro-level view from the hedge shows a very different financial landscape from that depicted in macro-level surveys. Far from being a declining and increasingly insignificant sector, informal finance in the study village, since the establishment of the village bank, has grown in terms of loan volume advanced by the pawnbroking businesses, the number of these businesses, and the number of mutual finance groups.

In contrast to the village bank, B. Jain's pawnbroking business supplies a multitude of "mini-loans" financing a great range of credit requirements. Moreover, loan requests are met instantly and service money needs, occurring at particular points in households' cultivation, domestic and ceremonial cycles. The loans extended within the pawnbroking business are not only greater in number but also more effectively reach disadvantaged formal sector target groups, compared to the village bank. Furthermore, in contrast to this bank, loan default within the pawnbroking business is low. Pawnbroking businesses in the village offer a viable, dependable, accessible and very private system of loan provision.

A micro-level view of a financial landscape also points to differences between informal intermediaries themselves. Moreover, linkages between informal financial intermediaries, as well as between informal and formal financial intermediaries, are also apparent. In addition, micro-level analysis shows separate types of credit advanced by the same financial agent.

True, the view from the hedge is a restricted view of a financial landscape and by its very nature cannot be generalized to a wider setting. However, a micro-level view portrays the intricate, living detail of financial landscapes, and although these details cannot falsify the findings of macro-level survey research, they at least warn caution with respect to basic measures of change in financial landscapes over time. Micro-level research shows a financial landscape with a sophisticated culture of indigenous finance, a culture that is not easily diminished, replicated or incorporated by formal financial institutions and authorities.

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19

The Question of Traders as Credit Agents in India

Barbara Harriss-White

From the time of the 1943 Foodgrains Policy Committees which advised on the necessity of state trading, until recently, policymakers in India have clung to an orthodoxy that private traders, especially agricultural traders, are inefficient and/or exploitative, prone to cheat, hoard and speculate. Generation upon generation of interventions in agricultural markets has used the need to "crush the middleman" (FCI 1980; UCO Bank 1989; GOI 1992) as their stated and ostensible justification. State trading had the stated objective of crushing mercantile power and of regulating and controlling international trade as well. Cooperative marketing was aimed at eradicating middlemen "where they are exploitative". Regulated marketing sought to reduce transactions costs to codify transactional practice and reduce the power of merchants by making private agricultural markets more open and competitive. Storage and anti-hoarding laws had the purpose of reducing price fluctuations caused by mercantile speculation, as did controls over futures trading contracts. State storage schemes were intended to reduce the concentrated control of inventory by merchants. None of these interventions was meant to benefit merchants (Harriss 1984).

It is entirely consistent with this orthodoxy that public sector credit should be lent to traders only under the strictest conditions. The Reserve Bank of India (RBI) curtails loans to private trade by nationalized and state-owned banks in three ways. One is exhortatory. Banks were "advised to keep a strict vigilance on advances and to check any tendency to utilize bank finance for hoarding" (RBI 1980: 20) with reference to circumstances when agricultural wholesale prices had risen despite "comfortable supplies". The second is mandatory. The RBI can set restrictions on the value of private traders' stocks on which loans can be given, and can specify interest rates to be charged, generally set at or near the formal sector maximum (RBI 1980: 12-13). The third mechanism of regulation is diversionary. Nationalized and cooperative banks are required to lend a majority of their deposits to priority sectors in which private trade is conspicuous by its absence.

Of late, the orthodoxy about private trade has been questioned. New institutional channels for credit are being experimented with. Financial self-help organizations, landless credit and savings groups on the lines of Bangladesh's Grameen Bank are one. But the suggestion with which this chapter is preoccupied, that private agricultural traders be used as credit agents, is another. Two different but related sets of circumstances have led to the present challenge: (1) the chronic failure of public sector, particularly cooperative, production credit, and (2) pressures to deregulate domestic markets, as part of the package of structural adjustment conditionalities.

The general cases for deploying food product merchants as credit agents for onward lending from public sector or state-regulated banking institutions takes four forms. The first argument, based on the formal assumptions of neoclassical economics, is that, since distortions in financial markets are the result of mismanaged state intervention (Seibel 1985: 390-391), then deregulation will "undistort" this market. The argument leads to the prediction that the (planned) use of traders as credit agents will increase credit for agricultural production, reduce interest rates, increase competition in rural financial markets and expand related markets for inputs, incentive goods, etc. The second reason assumes that financial dualism is eroded by the cooption of merchants and the use of their pre-existing transactional networks. The third argument arises from the inadequacies of capital formation to enable the development of privatized agricultural marketing systems. The fourth argument in favor of traders as credit agents is that this is the most cost-effective and feasible response to the contraction of bank lending caused by the collapse of nationalized banks (Adams and Meyer 1991).

By lending to traders for on-lending, banks reduce transaction costs. Traders represent a restricted clientele which could be cheaply screened according either to collateral or to license possession, and onto whom would be shifted the bulk of costs of loan repayment collection. Traders, in turn, possess low cost information about their clients, which reduces the costs of monitoring and enforcement. Their borrower-producers also face lower transaction costs. Information costs, costs of documentation, of access and of repayment are lower because of different customs for screening and collateral and because market transactions are minimized in repayment. Associated with the onward lending of traders is a range of interest rates and of social forms taken by interest.

In India, state regulated credit for agricultural production is part of a package of agricultural subsidies amounting currently to 3 percent of GDP. It has been estimated that the subsidy on agricultural credit alone touches Rs30 billion (£700 million sterling) (Katula and Gulati 1992). In India, the argument for selecting traders as credit agencies is part and parcel of a strong advocacy in favor of the liberalization of agricultural credit. This liberalization implies reducing subsidies by increasing interest rates, ceasing the targeted direction of credit and removing credit control on the finance of inventory (Parikh 1993: 7,19; Pursell and Gulati 1993: 16,19).

To use traders as credit agents is a controversial proposal in Indian agrarian conditions. First, costs of the monitoring and enforcement of fungible credit are indeterminate but very high. Second, and related to this, the existing theoretical models of exchange relations under differentiated owner-occupancy (Bharadwaj 1985) and under sharecropping (Bhaduri 1983) both predict that moneylending traders will encourage the pre-harvest indebtedness of small peasants on terms and conditions which tie their post-harvest sales. The marketable surplus will be price unresponsive and include an element of the producer's subsistence requirements which then requires repurchase on credit. Thus traders ensure a type of commerce which is "forced", not voluntary; and marketing takes place under "distress". Technical change and innovation adoption may be slowed down as a result. The further implication is that, unless we have evidence to the contrary, small-scale production may be perpetuated not by dint of superior efficiency (Lipton 1977) but because of compulsive debt relations with merchants, or because of a mixture of efficiency criteria and credit relations, the terms of which are thus crucial. These objections require further investigation.

Traders' Credit in Regional Agrarian Landscapes

Here we look at recent empirical work in regions of differentiated owner occupancy in South India (Rayalaseema and Northern Tamil Nadu), capitalist agriculture (Kungunadu in West-Central Tamil Nadu), and highly inegalitarian sharecropping regions in West Bengal. The distinctive feature of all these descriptive studies is that traders' credit is analyzed as part of property relations and of other markets.

Exchange Regimes in a Landscape of Differentiated Owner Occupancy: Dryland Rayalaseema

Two clusters of hamlets in southern Andhra Pradesh, one accessible and the other remote, have been studied by Olsen (1991, 1993). The agricultural economy is dominated by irrigated paddy and dryland groundnut. Agricultural production and the marketed surplus is dominated by relatively small capitalists and petty commodity producers (Table 1).

Rice is sold only by capitalist farmers and merchants. Groundnuts sales are dominated by capitalists, who nevertheless receive average prices little above those of small scale producers and below prices got by stocking traders. Olsen shows that there is a monthly price rise of 2-4 percent over a seven months period after harvest, the gains from which accrue to village traders.

Village traders dominate neither in terms of fixed assets nor in terms of numbers. They control the wholesale, retail and inputs markets, however, and are the major source of consumption and production credit, with sharp variations between the clusters of hamlets. While in the accessible hamlets 14 percent of all money borrowed by petty commodity producers was from traders and 34 percent from banks, in the remoter cluster (a few miles away) 63 percent was from traders and 4 percent from banks.

Olsen reveals how contracts tie all petty commodity producers' groundnut sales. These sales are carved up between traders and are effectively regulated, as Basu (1983) has hypothesized, by means of threats to withdraw credit not only to the indebted household but to third parties in case of non compliance.

Although merchants were a numerically small group (3 percent) they accounted for 25 percent of all principal borrowed (Table 2 and Table 3) obtaining bank credit for groundnut stocks at 12 percent interest and lending to producers at up to 24 percent. Olsen argues that bank interest rates have exerted a competitive deflationary effect on traders interest rates.

Olsen (1991, 1993) is the first to present systematic evidence of differentiated credit-commodity contracts under differentiated market structures. In the accessible cluster with a competitive market, traders lend money to capitalist producers and speculative sellers at zero interest as an incentive to repeatedly secure supplies. Petty

Table 1: Agrarian Structure and Exchange Relations in Rayalaseema

	% of hhs[a]	*Average Size of Land (in acres)*	*% of Groundnut Production*	*% of Groundnut Sold*	*Price (Rs/bag) in 1986-1987*
Laboring peasants	15	2.3	11		0 -
Petty commodity producers	30	4.4	46	11	195
Capitalist farmers	3	14.0	22	76	196
Merchants	8	3.1	12	11	217

[a] hhs: households.

Source: Olsen 1991.

Table 2: Principal Borrowed[a] (by Class of Borrower), June 1986 to May 1987

Class	*No. of Sample Households*	*Total of Principal (in Rs)*	*% of Total Debt*	*Principal per Household (in Rs)*
Landless laborer	17	15,915	5	936
Landed laborer	11	30,803	10	2,800
Petty producer	21	115,245	38	5,488
Capitalist farmer	2	31,500	10	15,750
Merchants	6	77,300	25	12,883
Other	9	15,655	5	1,739
Salaried	5	17,105	6	3,421
All	71	303,523	100	4,275

[a] Figures include principal borrowed before the survey began if still outstanding.
Source: Olsen 1991.

commodity producers are also lent money at zero interest, but the retail prices they pay as net purchasers are hoisted. In the remote cluster with a monopolistic market structure, speculative sellers are lent money at zero interest but have no alternative but to transact in wholesale and retail markets with the lender. Petty commodity producers are charged a high interest rate on credit and are also bound to the lender for transactions on retail and inputs markets at higher prices than those for speculative sellers. Such relations are termed "forced" or "distress" commerce by Olsen. Not only do class specific commodity exchanges vary with market structure, but so also do the extent and the terms of interlinkage between markets.

Olsen concludes that mercantile moneylending (1) reduces the freedom of debtors to borrow elsewhere, (2) results in higher retail prices than for unindebted purchasers, and (3) results in lower groundnut prices to producers combined with control over the timing of current commodity flows.

Exchange Regimes in a Landscape of Differentiated Owner Occupancy: Northern Tamil Nadu

The key differences between Olsen's localities and the one nearby in northern Tamil Nadu studied by Janakarajan (1986, 1993) are: (1) its proximity to a large urban marketplace, Kancheepuram, and (2) the advanced development of minor irrigation from open wells privately energized with pump sets. The latter have led to the development of a market for water, able to operate independently of the more limited one for land. The agrarian structure of this dynamic locality is a mix of landless laborers, petty commodity producers and capitalist farmers. The cropping system is one of increasingly less diversified rice cultivation.

Commodity trade in Janakarajan's locality is controlled by seven traders, one operating from the village, the rest from commission agencies in town. As in Olsen's case there is a spatial compartmentalization. This allows micro-monopsony conditions for contract formation between traders and sellers even when the numerical conditions for competition apparently obtain.

Traders' credit accounts for a smaller proportion (20 percent) of total credit than in Olsen's case (Table 4). A further contrast is that it is the water-selling, nascent capitalist farmers (WW: with water) rather than the petty commodity producers (NW: no water) who capture both traders' and institutional credit.

Janakarajan provides a descriptive model of triadic contracting involving traders' credit and commodities to the considerable disadvantage of petty commodity producers. Traders offer pre-harvest money to water sellers to secure paddy at below the market price. The implicit interest is annualized at 130 percent. Janakarajan (1986) derives this interest rate from purchase and sales prices and by assumptions about practices that pervade these contracts: illegal commissions (2 percent), false weighing (2.0 kg per 75), deductions towards the wages

Table 3: A Comparison of Outstanding Debts of Households in Nimmanapalle and Tavalam Village, January 1987

Source of Loan	*Percentage of Total Debt Outstanding*	
	in accessible Nimmanapalle (350 hhs[a] with a total debt of Rs140,000)	*in remote Tavalam (200 hhs with a total debt of Rs47,000)*
Indian bank	54	1
Private lenders	46	99 (including 34 percent from Itta R. Shetty)

[a] hhs: households.
Source: Olsen 1991.

Table 4: Source of Credit of Loans Outstanding (June 1983)

Source of Credit	*Value of Loans Outstanding (in Rs) by Category of Farmers*		
	WW[a] Category	*NW[b] Category*	*Two Categories Combined*
Institutional	106,150	4,400	110,550
Landlords	0	7,400	7,400
Moneylenders/pawnbrokers	56,400	13,725	70,125
Relatives and friends	144,880	41,620	186,500
Traders	87,250	5,605	92,855
Total	394,680	72,750	467,430

[a] WW: with water; [b] NW: no water

Source: Janakarajan 1993 (tabulated from field survey data, 1982-83).

of weighers (0.5 kg per 75), deductions for dirt and rot (1-3 kg), underpricing and uncompensated delayed repayment.

Two further conditions are attached to the contract. The first is to sell the entire marketable surplus, over and above what is owed for repayment of the loan, to the trader, violation of which was observed to be penalized by an extra 44 percent interest rate. The second involves a third party and makes the contract a triadic one. It is the stipulation that money, on-lent by the water seller to the water-share-cropper, shall be repaid by the water purchaser selling all his marketed surplus to the trader who lent to the water seller. The water purchaser has to comply, facing a monopsonist who will withdraw water supplies in case of non compliance. The water seller in turn faces a *de facto* monopsonist, however crowded the appearance of the commodity market. These ubiquitous trilateral contracts affect the distribution of the gains from technical change in agriculture.

Moneylending traders prefer the indirect control of production to direct assumption of ownership. The reasons are obvious: indirect control assures the supply of grain at minimal transactions costs and enables trading profits to diversify out of agriculture into higher return activities.

Exchange Regimes in a Landscape of Capitalist Production Relations: Coimbatore in Tamil Nadu

The hydrological regime of Coimbatore district is drier than in the first two examples. But the agrarian economy is rich and highly diversified thanks to energized lift irrigation, and is more dominated by capitalist production. This was a colonized frontier region with a large landless (or extremely petty-landed) labor force, which has since Independence become involved in rural industrialization (Baker 1983).

The distribution of assets in trade is highly concentrated and the top decile controls two thirds of all trading credit. A variety of sources may be tapped by any grain producer, even involving agro-industrial subcontractors (masterweavers lending to foodgrains producing powerloom weavers).

Agricultural trading credit operates quite differently from that in the maps so far. Two types of contract have been found. In the first, consumption credit in kind is provided by petty firms, from periodic marketplaces, to the agricultural and industrial labor force for repayment in cash. It is forced commerce all right, but confined to the assetless and nearly assetless wage labor force. Repayment is regulated via the mutual interests of lenders in the sharing of information about high risk purchasers and the withdrawal of credit sales to such individuals. Nevertheless, this credit is risky to the lender.

In the second case, traders' credit supplies a system of indebted agents at interest rates rising to over 36 percent at the base of the hierarchy where producers of irrigated agro-industrial crops, such as tobacco and cotton, meet traders. Contracts are marked not only by differentials in explicit interest rates, but by the less calculable costs of delayed, unsymmetrical and uncompensated payments for commodities by lenders to borrowers. The striking feature about trading credit in this developed area, however, is that the tying of money to supplies is much rarer. The borrower is able to repay a cash loan in cash and may deposit savings with the merchant (Harriss 1991a: 129-136). Both of these two contractual arrangements are likely to obtain only under conditions of comparative freedom of wage labor on the one hand and capital on the other.

Exchange Regimes in a Reformed Sharecropping Landscape: Birbhum and Burdwan Districts in West Bengal

Although tenurial reform in West Bengal has consolidated petty commodity producer forms of sharecropping, and major irrigation has improved environmental security, agrarian structures are still complex and heterogeneous. Changes in the modalities of surplus extraction leave small-scale producers little better off than before (Ghosh 1992)[1]. Ghosh's study of 615 tenants in 13 villages in Birbhum and Burdwan Districts in West

Bengal presents an historical account of conditions leading up to the present prominence of traders' credit.

The pace of compulsive commercialization by sharecroppers was forced in the early part of the century by the necessity to pay land revenue in cash. The lowering of levels of indebtedness by the time of the Great Famine in 1943 is evaluated as the unintended result of two Acts designed to regulate moneylending and protect debtors. These Acts encouraged erstwhile moneylenders to invest directly in land. Meanwhile famine beneficiaries who had acquired land stepped into the breach left by the moneylenders. Much later on in the 1960s, public sector credit, particularly from cooperatives, emerged as a challenge to the by then well established class of rich peasant moneylenders. But default and therefore mass ineligibility for cooperatives' credit helped this class to retain their preeminence in the loan market. These financial relations persisted until Operation Barga, presenting sharecroppers with the choice between recording their tenancies and foregoing landlord's loans, or foregoing their legal shares and taking these loans at high implicit interest. At this point, the rich peasant and landlords' credit dried up and a new set of financial intermediaries, wholesale traders and brokers in paddy, plugged the gap.

These moneylending traders control the paddy wholesale and inputs markets. It is estimated that over half the so-called Barga tenants have recourse to such credit. Loans stipulate the timing and price of kind payment. A tentative estimate for a region in Burdwan puts traders' credit in 1989-90 at twice the volume of that from nationalized and cooperative banks (Harriss 1991b: 51-52). Harriss' research showed clearly the importance of public sector credit in fuelling such contractual arrangements. Very large sums have been borrowed by traders and rice millers for onward lending at annualized rates of 120 percent, imposed on small traders as well as producers, and ensuring kind repayment and tied storage.

To sum up, the limited number of empirical works reviewed here, show that interlocked traders' credit contracts characterize the marketing systems of a variety of agrarian landscapes -- sharecropping and reformed sharecropping, petty owner occupancy and (for the labor force) under capitalist relations. The forms of crop and money markets and relations of exchange certainly do not prevent technical change, but do affect the speed and social profile of adoption as well as the distribution of gains. Financial markets cannot be assumed to be competitive. Credit contracts are one part of the economic dimensions of social relations of exchange.

The empirical work reviewed here suggests that relationships of traders' credit might contribute to the urbanization of finance, which in turn increases the velocity of rural-urban flows of money and increases the economic and spatial concentration of finance, as trading firms combine to invest in "finance corporations" (Harriss and Harriss 1984). Under these conditions, disadvantaged cultivators will enjoy lower returns to production and have disproportionately fewer resources. However, traders' credit cannot be generalized *a priori* either as exploitative or as developmental.

The longitudinal study of agrarian change in North Arcot District of Northern Tamil Nadu, for instance, revealed a real expansion in agricultural credit from nationalized and cooperative banks of only 14 percent during 1973-83 when production doubled, while pawnbrokers and private finance corporations increased by factors of ten and more (Harriss 1987, 1988: 454). And public sector credit confined more or less to the larger producers in both 1973 and 1983, had only increased from 32 percent of total credit to 40 percent (J. Harriss 1991). So the role of the state in contesting traders' credit can be exaggerated.

Credit Supplies to Agricultural Trade

We saw in the introduction how the Indian state sets severe constraints on the finance of trade, especially that in staple foods. Yet several of our cases showed credit from nationalized and cooperative banks being accessed by traders, particularly the biggest ones. How can this be?

To our knowledge, this sensitive subject of state finance to traders has never been researched properly. Our discussion here relates to evidence marshalled for South India about a decade ago, so will be factually out of date (Harriss 1980) but still contains important lessons. The scale has to change from that of the last section, and the description of the financial landscape is more general because of data constraints. To compensate

1. Ghosh's work provides some exceptionally interesting insights. The class of landlords is large and socially very varied (because of the importance of the local rural non-farm economy, because of migrant participation in the non-local urban and industrial and service economy, and because of life cycle factors). New forms of tenure are rapidly emerging, in particular seasonal leasing in order to evade tenancy legislation. Tenants lease from more than one landlord and landlords lease to more than one tenant. Within a given village, crop shares under the same tenurial form can differ considerably, because of: (1) the relative prices of main and byproducts (shares in which are never quoted), (2) a continuum of relations of cost sharing, and (3) landlord-trader credit interlocking the product share with kind repayment. Formal lending has not cracked such relations which prevent the cultivator from the direct realization of his legal share (Ghosh 1992, chs. 4-6).

somewhat, the description has been put in an historical perspective. It is certain that the processes described then are at work now.

State credit to traders first began in Tamil Nadu in 1967, when American pressure was being applied to free the fertilizer distribution network from the stranglehold of the cooperatives (London 1975). This required vigorous promotional marketing. Traders' credit started with kind advances at zero interest from public sector fertilizer distributing companies to private dealers, who then lent onward at interest. Private companies rapidly followed suit with credit borrowed from nationalized banks on concessional terms.

These fertilizer dealers were almost always paddy and rice wholesalers too, some specifically selected as such. Intra-seasonal paddy and rice storage, encouraged as much as was onward lending, was a strategy of low risk and assured return for the principals.

But secondly, the state also funds grain traders through fungible loans for Small Scale Industry, through short term crop production loans and medium term livestock or land improvement loans: 80 percent of the traders studied in Coimbatore District and 75 percent in Burdwan district were landowners.

Thirdly, although trade is not listed as a priority sector for formal credit, an interesting feature of Priority Sector credit concerns that targeted at "small enterprise", the "tertiary sector", "services", "retailing business" and so, euphemistically, on. According to evaluations by Lead Banks in their Credit Plans, these particular targets for directed, subsidized credit always overachieve. Merchants at the apex of the system of trading and credit, whose assets averaged 200 times those of the mass of licensed and unlicensed petty traders at the base, were able to obtain credit from the West Bengal Finance Corporation and the National Cooperative Development Corporation averaging Rs90 lakhs (£200,000) per firm. The eight largest firms in our survey had state credit equal to 20,000 Integrated Rural Development Programme loans (Harriss 1991b: 52-55, 78).

Fourthly, state credit can also be got on concessional terms on the basis of private receipts for goods for which support price have been announced, stored with the Central and State Government Warehouse Corporations. Banks are asked to guard that the borrower is a *bona fide* farmer. Many of the latter are also *bona fide* traders.

Lastly, nationalized banks can and do give financial guarantees to rice milling and trading firms to enable them to operate on contract to the Food Corporation of India. This is a low risk, high capacity utilizing option and liberates traders' own working capital for other adventures.

There are also a number of direct support mechanisms. Nationalized banks are strongly supportive of regulated marketing. Successfully regulated markets physically centralize trade and improve traders' access to banks. Nationalized banks have been investing in branches located in urban and rural regulated marketplaces (Harriss 1984: 265). Also, nationalized banks extend unsubsidized credit to traders. We have case study evidence of Rs12.5 lakhs of loans to 25 combined cotton-and-grain merchants from one bank branch alone in a town not far from Coimbatore in 1980. Individual traders could and did register legally under different names at different banks, commonly at up to 10 banks (Harriss 1984: 263). Further, the World Bank and IDA via the Agro Finance Development Corporation have financed the private ownership of an estimated 8 million tons of agricultural storage.

The Indian state thus finances private trade on a massive scale. But the capacity of the RBI's machinery to check and regulate the lending of banks to traders was grossly inadequate.

Private Traders as Agents of State Credit

Traders have been formal sector credit agents in India on a large scale for at least two decades. But this credit agency has been unregulated by banks, dominated by the largest traders and secret from the banks' point of view. It is ironic that the major assumed fault line between the so-called formal sector and the informal sector does not reinforce financial dualism but instead is highly permeable. But it does reinforce complex social and economic relations through interlocked contracts.

This onward lending has a number of highly desirable features for state sector lenders. Most importantly, although their borrowings are often at subsidized interest, mercantile borrowers can operate in a production environment with high co-variate risk but at low default risks and at the interest ceiling. Further, from a social banking perspective, traders can lend for consumption as well as for production at lower transaction costs than do banks since they exploit the informational transparency that results from social embeddedness.

Traders' onward lending might also have undesirable features for precisely the social classes to the development of which nationalized banks are stated to be committed. These classes, while being numerically strong, are economically weak and supply little of the marketed surplus. The terms and conditions of traders' credit cannot be explained only in terms of administrative costs and risks (even though the latter are practically incalculable). Janakarajan showed that in Northern Tamil Nadu oppressive terms and conditions could operate at one further remove from onward lending to "progressive" or capitalist farmers. Moreover, traders' credit contracts might carry adverse intangibles with them: (1) claims to future labor (Olsen 1991), (2) ties of all marketed surplus (Harriss 1991b; Janakarajan 1986), and (3) asymmetrical and uncompensated payments (Harriss 1991b). Traders' credit can be bound up with illegal deductions, chicanery with weights and measures, under-declaration of prices, etc. (Janakarajan 1986). Lastly, the sheer numbers of borrowing traders is a misleading indicator of a competitive transactional domain. There is evidence of their capacity to cartelize and clientilize markets into micro-monopolies and, in certain cases (Crow and Murshid 1992) to be capable of physical enforcement of a cartel. Indian agricultural trading firms are not necessarily risk averse and are likely to be opportunistic in relations with small suppliers and in backward regions with a low density of banks.

Given that traders are credit agents, a series of related policy questions arises: first, could traders' credit agency be regulated? For this a bank has to have information about the actions of traders and the capacity to enforce sanctions against undesirable actions. This means there has to be a set of desirable actions defined and agreed by traders and bank alike. We have seen that the developmental impact of traders' credit varies with the agrarian landscape and with the class position of the borrower. Thus, the major challenge is to describe existing transactions and networks of traders in different socio-economic environments. Such an effort might be helpful to better appraise the possible effects and side-effects of the use of traders as credit agents. However, such information is not easy to obtain, and, provided traders repay loans, banks have no incentives to collect such costly information. Nor can they necessarily enforce, given the necessity of banks to lend, the likely prevalence of triadic sanctioning relations (if they cannot enforce all misdemeanor, they are unlikely to enforce any), and the common subversion of the legal process.

Second, could credit be extended to traders, positioned lower down the post farm system, to act as credit agencies? This would enable small traders to compete with the magnates. If small intermediaries competed in onward lending, then higher risk producers currently excluded from both "formal" and "informal" financial markets might be drawn in.

The answer to this question would have to be approached in an integrated way, because a number of related policies, not only in finance but also in marketing, bear on it: (1) the diffusion and siting of branch banks, (2) technology policy (currently biased in law if not in practice towards gigantism), and (3) licensing of traders. The screening costs to minimize adverse selection would be formidable. It might be possible to invite self selection by extending credit in kind (shops and sacks, rickshaw carts, mud stoves for parboiling, small capacity mills, etc.).

However, the use of smaller traders as credit agencies would make the Regulated Markets Acts even more difficult to implement, because the physical centralization of the first post-farm commodity transaction is unimplementable under conditions of decentralized traders' credit. It would exacerbate the problems of monitoring and enforcement discussed above, because loans would be numerically much larger, with consequences for the fixed cost element in loan administration.

Third, should credit agency be tightened in view of its adverse impact? Traders' credit does not invariably have an adverse impact especially when compared to conditions in its absence. Ghosh's account of the unintended impact of two Moneylending Acts in Bengal in the thirties should alert us to the deprivation of consumption credit to laboring peasants which results from a withdrawal of such credit. If the class structure remained unchanged and the state stopped lending to traders who on-lend to the poor, then the poor are likely to face a hitched-up range of interest rates and/or tighter screening so that some may be rendered ineligible for loans altogether.

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20

Moneylenders and Merchant Bankers in India and Indonesia

Heiko Schrader[1]

Rural (and to a lesser degree urban) finance nowadays forms one of the key concepts of development planning. Access to cheap capital at the grassroots level is identified as a means for development. Among perceived obstacles to development are the insufficient creditworthiness of the target groups and traditional forces such as moneylenders, who -- depending upon the particular concept -- have to be eliminated, curbed by competition or integrated for the sake of development. Unfortunately, development planners are subject to a high degree to means-end rationalizing, which limits their perspective to the present and future of their specific settings.

The author considers past history important, in the sense that contemporary financial landscapes and regional differences are largely a result of processes in the past, transcending national political levels. Professional moneylenders such as the Chettiar in colonial Asia are a structural phenomenon of expanding merchant capitalism. Once a market integration of certain regions has been achieved, such moneylenders eventually lose their function as they are replaced by banks, and they move into other business-related or industrial activities. Besides such large-scale professional moneylenders there have been, and still are, many various small-scale part-time moneylenders in developing countries. They belong structurally to the market economy, providing credit to marginalized people beyond the scope of banks (Schrader 1992).

This paper will test this hypothesis with a review of professional large-scale moneylenders in pre-colonial and colonial India and colonial Indonesia. Scholars of Indian financial history stress two issues in particular. One is the growing rural indebtedness during the second half of the nineteenth and early twentieth centuries, the other is the “indigenous banker” who still participates in the Indian economy. The literature on Indonesian history has no direct evidence of professional large-scale moneylenders or indigenous bankers. The colonial literature focusses on changes in society and economy and, at the turn of the century, the “ethical policy”, two facets of this policy being popular credit and public pawnshops. One may, therefore, ask whether in Indonesia there were no professional large-scale moneylenders who pushed forward market integration and, if not, how this is to be explained. To provide a possible answer, the financial landscapes in both countries will be reviewed.

India: Moneylenders, Indigenous Bankers and Commercial Banks

Definitions

According to the Study Group on Indigenous Bankers (1971), hereafter SGIB), a moneylender lends his own funds, while an indigenous banker acts as a financial intermediary by accepting deposits or making bank credit available. While moneylenders do mainly cash transactions, indigenous bankers deal in short-term credit instruments (*hundis*[2]) for financing the production and distribution of goods and services (SGIB 1971: 9). The profit of indigenous bankers is based on the quick turnover of capital. They prefer lending high amounts to a limited number of clients and to leave the financing of agriculture to moneylenders.

Indigenous Bankers Until the Mid-Eighteenth Century

According to Habib (1964), medieval India ranges from about the beginning of the thirteenth until about the mid-eighteenth century, i.e. until the introduction of British rule. During the medieval period the Mughal emperor Akbar had introduced a common monetary system, free movement of goods and a system of land allocation and taxation throughout the empire. Moneylending and indigenous banking were already ascribed to certain castes, and were found all over the country. Almost all peasants demanded short-term loans to bridge

1. The author is indebted to the Deutsche Forschungsgemeinschaft, the sponsor of his current research on “Moneylenders and Informal Credit Markets -- Sociological Aspects of Monetization and Market Integration in Developing Countries”.

2. A clear definition of a *hundi* has never been provided by any authority on banking. *Hundis* perform three functions: (1) the raising of money, (2) the remittance of funds, and (3) the financing of inland trade (for details see SGIB 1971: 48f).

the income gap until the next harvest, to pay taxes and to pay for social events. Credit suppliers were various semi-professional lenders such as village headmen, well-off agriculturalists, traders, *zamindars* (tax farmers, revenue collectors and landlords) and some professional moneylenders. Demand came from peasants, artisans, merchants, and nobles. The rates of interest varied widely and depended upon the security offered. Repayment normally took place in kind, by labor service or sometimes by the sale of the debtor's children (Goldsmith 1987: 113). Sometimes whole villages were indebted to *mahajans* (moneylenders) to pay land revenue and repay old debts.

While the financing of cultivators was a matter for moneylenders of various kinds, indigenous bankers were concerned with the financing of trade, nobles, the state, and the emerging East India Company. Most of them were merchant bankers. Commercial interest rates varied considerably according to place.

Medieval India consisted of a complex web of cash and kind credit from the village level up to the highest commercial plateaux, provided by moneylenders for the financing of agriculture and indigenous bankers for the financing of trade. A third sphere was the financing of the state by certain top indigenous bankers: treasurers, minters, money changers and financiers of the government production units (*karkhanas*) and of the monumental Mughal architecture. These credit agents existed in spite of the strict prohibition of interest by the Qur'an, which was circumvented in many ways.

With her "great firm theory" Leonard (1979) goes beyond a pure description of indigenous bankers during the Mughal period and makes them responsible for the decline of the Mughal Empire. Others hold the increasing indebtedness of peasants to *zamindars*, and resulting rebellions, as well as an inflated superstructure, as responsible for its decline. Leonard's argument runs as follows. The rise and maintenance of the Mughal empire required a strong central administration and a coalition with strategically important groups and institutions to keep down various oppositional élites. Traders and bankers were important for the provision of goods and cash to the "unproductive" administration. A monetized market economy and a complex system of credit was already existent. The "great firms" were multi-purpose enterprises that included indigenous banking. When the trade in Surat harbor declined for lack of state protection, these firms began to look for business elsewhere, such as revenue collection or financing other emerging powers, particularly the East India Company.

Leonard's argument is supplemented by Subramanian (1987: 510), who even speculates that the rise of the Company at the West Coast was assisted by Surat and Benares indigenous bankers. Toward the end of the eighteenth century, however, the British tried to free themselves from dependence on indigenous bankers by issuing government bonds and institutionalizing their own banks. This coincided with a step-by-step reduction of the functions of indigenous bankers. The British abolished the farming-out of revenue collection in 1778, renounced the take-over of debts of former rulers to indigenous bankers, incorporated the import-export trade, eventually appropriated the minting rights and introduced a single currency (1834-35) for all-British India.

Indigenous Bankers in British-India and Independent India

The reduction of the functions of indigenous bankers, however, did not make them disappear. The British believed in economic liberalism and a self-regulating market, and did not introduce -- parallel to the decentralized administration -- a well-organized and decentralized financial system. During the colonial period there existed, as Tomlinson (1979: 8) calls it, "a three-decker-system of credit institutions which, linked together to some extent, were capable of running along distinct and sometimes diverging lines". It consisted of British exchange banks with their branches in India, Indian import-export firms and Indian and expatriate joint-stock banks, and indigenous banks. I see another three-tier distinction: an upper one for the financing of import-export trade and the colonial state (banks and British import-export firms), a medium one for the financing of domestic trade (indigenous bankers with certain refinancing possibilities at banks), and a lower one of financing agriculture (moneylenders of different forms). In addition to the organizing and financing of domestic trade in India, the British expansion to Burma, Malaya and Ceylon provided new opportunities to indigenous bankers for the financing of pioneering activities in trade and agriculture, that is, risk finance in which banks were not willing or able to participate. Increasing rural indebtedness during the second half of the nineteenth and early twentieth centuries together with land alienation caused the British eventually to interfere with the money market by passing legislation on moneylenders and usury. Their hesitation stems from the dilemma of depending on moneylenders for pre-financing land revenue payment by cultivators, while also fearing peasant revolts resulting from increasing rural indebtedness and land alienation (cf. Dhanagare 1991). The new laws required the registration and licensing of professional moneylenders, adequate recording of transactions and accounts, and issue of receipts for all payments made by debtors. However, few moneylenders complied.

Official interference with the financial market has continued after independence. As a whole, the importance of informal finance has decreased during the post-colonial period. The SGIB (1971: 113) estimates for 1968 a total of almost 34,000 moneylenders and indigenous bankers, of which more than 19,000 are urban based.

The interest rates of indigenous bankers vary according to place, type of the loan, security provided, duration, etc. Prevailing rates of interest reported for the 1970s are 18-36 percent per annum. Risk loans bear an interest between 6.25 and 12.5 percent per month (Timberg and Aiyar 1980: 280). Some indigenous bankers accept deposits, offering deposit rates.

In nineteenth and twentieth century India the important indigenous bankers were Multanis, Gujarati Shroffs, Marwaris, Nattukottai Chettiars and the Kallidaikurichy Brahmins. Most combined banking with trade, and nowadays with commission agency business or hire-purchase financing. Few of them are pure bankers. The bulk of credit provided is for commerce and small- and medium-scale industries. Special demands come from such enterprises which have no physical security to offer.

Various committees have suggested the integration of indigenous bankers in the formal money market, but the indigenous bankers' association rejects this. The SGIB considers the indigenous bankers an indispensable link in the money market for certain neglected sectors of the economy such as small-scale trade and industries. With the nationalization of commercial banks in 1969 and 1980 and the application of a multi-agency approach, formal credit has been geographically and sectorially expanded (Bouman 1989; Balamohandas 1991). However, until now the indigenous bankers have found niches which are insufficiently covered by banks or government credit programs.

To sum up, most of the indigenous bankers in India moved into merchandizing-cum-banking or pure banking already before the advent of the British. The main field of finance was trade, both foreign and domestic. The Mughal period is generally considered to have formed the heyday of indigenous banking business. Later, and especially after the emergence of British-India, indigenous bankers were deprived of some of their functions while, on the other hand, the colonial economy provided new opportunities of opening-up regions for cash-crop production and estate business. Increasing interference of the British with the financial market during the late colonial period as a reaction to growing rural indebtedness, and of the Indian government during the post-colonial period with moneylending and usury laws and the systematic promotion of formal banks[3], have led to the decreasing importance of indigenous bankers.

But what became of them? Particularly from the 1930s onward, Marwari, Gujarati, Parsi, Punjabi, Chettiar and others invested in commerce and industries (cf. Bagchi 1972; Ray 1979; Goswami 1989), the analysis of which goes beyond the scope of this paper. The long-term development of indigenous bankers reveals their high degree of adaptability to changing circumstances and opportunities and supports my argument that indigenous bankers are a structural phenomenon of merchant capitalism, with an eventual substitution by banks. However, the same business groups reappear in other sectors of the economy with better opportunities for capital accumulation.

Indonesia: Petty Moneylenders, Chinese Networks, Banks and Government Credit

The literature of the Dutch colonial period has two major foci, monetization and credit in a dual economy, and rural credit that was provided by moneylenders and, after 1900, by the popular credit system.

Pre-Colonial and Colonial Economies

Contrary to the highly developed economy of medieval India, scholars describe pre-colonial Indonesia as a predominantly agricultural, static subsistence society, remaining unchanged until 1800. Surplus was extracted by the feudal élites through taxes, rent in kind, forced labor and, to a limited degree, money. During the period of the *Vereenigte Oostindische Compagnie*, (Dutch East India Company, hereafter V.O.C.) which was wound up at the turn of the nineteenth century, regional rulers had to provide rice, coffee, cotton etc., and labor against small compensation (*contingenten*) or for free (*verplichte leverantien*) and in turn forced the peasantry to deliver these in addition to the revenue for the rulers. During this period Indonesia was less monetized and less integrated into world trade than pre-colonial India.

Budgetary deficits of the colonial government and the interest in exploiting the colony led to the introduction of the Cultivation System[4] in 1830, which lasted until around 1870. The colonial government, like the

3. The early development plans of independent India were designed to develop infrastructure and industries. Commercial banks acted primarily as short-term financiers. With the Green Revolution, the awareness of the importance of finance for agriculture and backward areas increased, and commercial banks were encouraged to offer more credit to priority sectors. In 1969 and 1980 the government nationalized various commercial banks. The number of offices rose from around 8,350 in 1969 to more than 42,000 in 1983, of which more than half were in rural regions and 9,000 in semi-urban ones (Balamohandas 1991: 1-21).

V.O.C., employed middlemen (Westerners, Chinese and *priyayi*, indigenous nobles), for communication with the population. The Chinese controlled trade and moneylending, tax-farms (local and regional monopolies farmed out to private persons) for toll posts, markets or opium, and financed the feudal élites and indirectly of V.O.C. and the colonial state. In trade, they organized the flow of export goods from the inland to the harbors, while the Dutch monopolized the export.

The change from *Cultuurstelsel* to private enterprise, and the Agrarian Law of 1870, replaced forced labor by wage labor contracts, and forced commitments of land by land rent and land lease, while simultaneously land transfers to foreigners were further prohibited (Burger 1975; Suroyo 1987).

Toward the end of the nineteenth century indigenous welfare decreased significantly as a result of the world sugar crisis in 1884, population growth and increasing scarcity of land. A call for state interference, a reflection of the *Zeitgeist*[5], was manifested in the “ethical policy”, with the introduction of an agricultural and irrigation system, the popular credit system (later *volkscredietwezen*) and the government *pandhuisdienst* (pawnshops).

Credit

I shall initially distinguish two levels for credit in colonial Indonesia. The upper level largely financed exports, the estates and the processing factories. It consisted of state credit, later bank credit, and advances of exporting firms to intermediaries, estates and processing firms. Large-scale private indigenous credit has probably played an insignificant role in the financing of these export crops.

The lower level of credit consisted of the traditional credit relations in kind within the village, which were subjected to moral obligations and customary law, and of commercial credit relations of merchants-cum-lenders and pure moneylenders, not much different from India. One form was credit in cash or kind, to be repaid in kind after the harvest (Deventer 1904: 228). Typical were advances by Chinese merchants to farmers on standing crops (*ijon* or *idjon*). The professional moneylenders were mainly aliens: Chinese and to a lesser extent Arabs, Chettiar, and Europeans. The increase of credit and rural indebtedness occurred parallel to monetization. Dangerous for the farmers, argues Gonggrijp (1922: 540), were not so much the foreign moneylenders to whom land transfer was prohibited, but rather the Indonesian lenders. Private landownership allowed for the mortgaging of land to indigenous lenders. Did the “foreign Oriental” and European moneylenders provide a separate sphere of financing domestic trade?

The Ethnic Component of Moneylending

Arab moneylenders used to operate in Java in towns between Cheribon and Semarang. Colonial literature describes them as the most usurious and violent lenders. European moneylenders worked secretly, so that hardly any data on them exist. Indigenous moneylenders are a more current phenomenon.

Tjina mindering[6] were the Chinese itinerant moneylenders in Java who provided small-scale installment credit to villagers, market vendors and small artisans. Since they lent on personal security, their debtors were not in danger of losing land or means of production, such as buffaloes. They pedalled to villages by bicycle to collect installments and to offer new loans and repayment terms, adapted to the requirements of the borrowers. Amounts ranged from one to 100 guilders. For the colonial period, typical loan examples on market days are: f1 in the morning, repaid at noon with f1.01 to f1.05; or f1 to be repaid in 12 installments of f0.10 per market day, i.e. f1.20 in total; or f5, to be repaid in five weekly installments of 1.20 or f6 in total (Gutem 1919). Recent field work in Java has shown that the *mendrik* still practices in a similar way. However, the Chinese itinerant trader-cum-lender has largely been replaced by indigenous people.

In addition to *mindering*, Chinese moneylenders have combined merchandizing and shopkeeping with trade, making the moneylending aspect less apparent. During the colonial period the biggest lenders lent on

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4. Originally designed as voluntary, the *Cultuurstelsel* (Cultivation System) soon became one of forced cultivation. The products were processed in factories or mills, established by entrepreneurs/contractors with government loans, mostly Europeans and Chinese. The processed goods were exported to the Netherlands by the *Nederlandsche Handel-Maatschappij* (Netherlands Trading Company) enjoying a state monopoly, and auctioning into international channels. The system got into difficulties after the 1840s.
5. The second half of the nineteenth century saw the birth of the European cooperative movement. The core idea was the protection of the common people from the harsh effects of industrialization and market integration.
6. The Dutch word *mindering* means “reduction” (of credit, paid back in instalments). Burger (1930: 397) argues that, after the obligation that Chinese need a permit for traveling within Java had been abolished, the number of *Tjina mindering* increased.

mortgages to other Chinese or Europeans and employed lawyers to set up legal contracts. Reasonable interest rates are reported. Both Chinese and Arabs provided loans to civil servants and employees (Coolhaas n.d.: 112).

Chettiar research has overlooked the operations of Chettiars on the East coast of Sumatra as the outposts of Indian-based firms. The first Chettiar reportedly came in 1879. In the 1920s Medan was the main center of Chettiar moneylending activities (Westenenk 1922). Their approach was similar to that in other countries, they had overdrafts at banks and accepted deposits. Moneylending ranged from f100 to sometimes f50,000, usually against promissory notes; for high sums collateral was required. Interest rates were 12 to 24 percent per annum for big loans and higher for small amounts (Schoorl 1926). The profit of a Sumatran agent after a three-year period ranged from f20,000 to f50,000, but amounts of even f200,000 have been reported. The total capital of the seventy Chettiars in Medan has been estimated at between f10 and f12 million.

Chettiars and the big Chinese and Arab lenders provided a medium level of credit, comparable to some indigenous bankers in India. However, their number was rather limited. Indigenous banking firms in India had far-spread financial and trading networks. Were there comparable networks among the Chinese, and did the *Tjina mindering* belong to such networks?

The Economic Role of the Chinese in Indonesia

Chinese migrants in Indonesia have been engaged in trade for centuries. In addition to coolie labor, which by far outnumbered other professions, they were engaged in trade between indigenous cultivators and exporting companies, tax-farms, contracting for public work, sugar and saw mill contracting, arrack production, or as artisans. In 1835 the Cultivation System inspired a decree to have the "foreign Orientalists" live in separate quarters under their own chief and to restrict their free travelling (pass law). Although new immigration of Chinese was prohibited in 1837, shortage of skilled labor forced a revocation of this decree. The pass law, however, remained and was revised in 1863.

Rush (1990: 83-107) describes the role of the Chinese in opium farms, introduced in 1809 and replaced in 1904 by the Dutch-managed opium bureau, the *regie*. His description of Chinese patronage networks is here of interest. In many cases the tax farmers were high officials, with considerable power over the Chinese community. In addition, tax farmers were excluded from settlement and travel restrictions. The tax farms supported therefore Chinese patronage networks, which spread from the coastal cities and towns to the countryside. Various opium-farm-cum-official combines existed, each representing a complex network of economic relations, family liaisons, and cultural and contractual obligations. These *kongsi* (joint living and business houses) included tax-farms[7], commercial agriculture, light industry and networks for the flow of inland produce to the harbors and distribution of imports in the country, where they were sold in shops and by pedlars. In most cases, members of a *kongsi* held different monopolies in the same region. After revision of the Agrarian Law (1879) the Chinese quickly stepped into estate business, construction, transport, etc. Opium farms, argues Rush, provided the *kongsi* with the necessary capital for the provision of credit to farmers, and allowed them to control the inland trade.

The abolition of the opium and other monopolies in the early twentieth century, replaced by government control, deprived the Chinese élite from their major income. Adaptation to other professions was necessary. Some Chinese invested in the sugar industry, others in food processing, tobacco industries, or batik factories. Many of them again became involved in trade/commerce including import-export with Chinese in Singapore, Thailand, China and Indo-China. However, many enterprises were medium or small-scale family firms, and only few entered heavy industry or developed into multi-corporate enterprises. Furnivall's (1938) assumption that, after World War I, the Chinese in Java had a stronghold in banking, has been rejected by The Siauw (1989: 173-174). On the Outer Islands there was a strong Chinese engagement in the production of raw materials and in trade[8].

7. In 1850, besides the lucrative opium farm, the following "small means" existed: bazaar leases (i.e. the right to tax goods offered for sale in the bazaars), abolished in 1851; the slaughtering of cattle and pigs; fishing and the supply of fishing nets, abolished in 1864; the sale of arrack and liquor until 1864; the practice of certain occupations, the poll-tax on Chinese, the import and cultivation of tobacco; toll bridges, river crossings and sluices; the harvesting of birds' nest; timber from forests; the products from the "Thousand Islands" close to Batavia; *wayang* performance; pawnshop and gambling house leases (The Siauw 1989: 161).
8. For 1921 Cator (1936: 64, quoted by The Siauw: 173) has estimated a total investment by Chinese of f340 million or 10.6 percent, compared to f2,350 million or 74.4 percent Dutch investments and f300 million or 9.4 percent British investments.

Volkscredietwezen, Pandhuisdienst and Banks

Unlike in India, rural indebtedness in Indonesia gave no cause for serious discussion. One reason was that land alienation was constrained by legislation, another was the Dutch introduction of a popular credit system and public pawnshops[9]. Their introduction supports my argument that, unlike the British, the Dutch interfered extensively with the money market -- as before in the commodity market through the Cultivation System.

To sum up, the British in India applied a *laissez faire* policy that left room for different types of indigenous finance, but simultaneously produced increasing rural indebtedness and land alienation. The Dutch mercantile policy, on the other hand, favored market restriction, with various state monopolies and tax farms. Such an interventionist policy allowed for a speedy reaction to increasing rural indebtedness, at the expense of private entrepreneurship. This brings us to the central question: to what extent could Chinese as the only entrepreneurs in such a restricted market constitute financial networks comparable to those of indigenous bankers in India?

Conclusion

In the Netherlands Indies, there were no specialized credit agents comparable to indigenous bankers in India, with the exception of the Indian Chettiar in Sumatra and some Chinese and Arab moneylenders. On the other hand, multi-functional Chinese networks existed, ranging from the high ranking tax farmers-cum-bureaucrats to itinerant moneylenders in the countryside. They controlled almost the whole private sector of trade and finance. How can we explain the different financial landscapes of colonial India and Indonesia?

First, in the pre-colonial period large parts of India belonged to an empire which had a highly developed monetized, partly industrialized economy, and was to a high degree involved in foreign trade. According to Alavi (1962), the British systematically undermined the existing Indian cottage industry to promote their own textile production and pushed back the Indian economy to a level of raw material production and a market for British products. In contrast, pre-colonial Indonesia was divided into many states and islands of which only a few were involved in foreign trade, while most of these states had subsistence-oriented economies.

Second, during the colonial period the economic and political situations in England and the Netherlands, as well as their colonial practices[10] were different. According to Furnivall (1956), liberalism combined a double aspect: material and moral, economic and social. British colonial practice developed on the premise that individual freedom and freedom of property and trade would lead to progress. This doctrine implied a money economy and merchants to build up a colonial market of export of raw materials and import of British industrial goods. The British constituted the legal framework of a market for production factors. Land became private property and transferable. Import-export trade was advantageous for British private capital. The land revenue system provided the state finance. However, the laissez-faire colonial style resulted in unexpected side-effects from the mid-nineteenth century onward, such as increasing rural indebtedness and land alienation, defying the assumption that the moral system of Hinduism would protect against the disruptive forces of the market. Therefore, state interference took place very hesitantly. Moneylenders and usury laws were introduced as late as the late nineteenth and early twentieth centuries, and the cooperative movement was vigorously promoted from the early 1900s. The interference, however, did not go so far as the introduction of a popular credit system as in Indonesia.

Quite different was the colonial practice in Indonesia. Following Furnivall, Tichelman's (1980: 113-125) analysis starts from the point that the industrial-capitalist colonial exploitation of Indonesia started very late because of a weak Dutch capitalist class. Raffles' British interlude had only limited success in bringing the Javanese peasant into direct touch with the market, because of the overall stagnation of society, the absence of any dynamic capitalist sector, and administrative failings. Raffles' policy was considered unsuitable for the indigenous population. Instead a "liberal policy adapted to their character and institutions" was pursued with the Cultivation System, based on state monopolies, and the maintenance of indigenous institutions for the administration.

With the 1870 Agrarian and Sugar Laws, private estate enterprise became possible on land from the govern-

9. The *Volkscredietwezen*, with its district, village and *padi* banks was introduced in 1913 primarily to provide consumption credit, while cooperatives were intended to provide production credit (see e.g. Schmit 1991). In 1903 the government monopolized the running of pawnshops. Although public pawnshops were not introduced to make profits, they contributed to a government revenue of 163 million guilders between 1904 and 1938.

10. Furnivall (1956) distinguishes colonial policy and practice and argues that both British and Dutch colonial policies were based on the ideology of liberalism, while colonial practices developed differently: British India from "direct" to "indirect" rule and the Netherlands Indies from "indirect" to "direct" rule.

11. All land for which private ownership could not be proven was declared "state domain".

ment domain[11], or on private land hired or rented from Indonesians. In all colonial phases, argues Tichelman, the Dutch channelled Indonesian products into the world market, while the indigenous people were kept away from that market and from capitalist development. High finance in the Netherlands showed no interest in investing until the early twentieth century.

From 1870 onward, private capital began to penetrate Indonesia and weaken the colonial bureaucracy, which still continued to play the role of the "protector" of Indonesian society. For the indigenous people, this period meant a much heavier exposure to the money economy, much higher tax obligations and labor services. During the "ethical period", the Javanese standard of living fell dramatically, with a simultaneous improvement of the infrastructure, necessary for the expansion of capitalism. The years of anti-colonial struggle (1918-19 and 1923-27) hit the Dutch rather unexpectedly and their reaction was reactionary and authoritarian. This "frustrated" the rudimentary attempts at industrialization and development of Indonesian capitalism. The period was one of maintenance of the status quo and a de-liberalization of the "ethical policy" (see Kat Angelino 1931).

Colonial practices in Indonesia and India can be explained by the economic and political conditions "at home". According to Tichelman, the specific evolution of capitalism during the late nineteenth century, with its concentration and centralization of capital and production, monopoly formation, intertwining of banking and industrial capital, falling profit rates and surplus capital export, had barely begun in the Netherlands. In other words: the Dutch did not, like the British, build up their own industry by importing raw materials from their colonies to process and re-export them as final products into the colonial markets. For a long time, they continued a mercantile exploitation policy, appropriating raw materials and produce and selling these in the world market. The related monopoly kept down Indonesian trade and shipping and confined Java and most of the Outer Islands to agricultural and estate production.

The lack of financial agents in Indonesia, comparable to indigenous bankers in India, can hence be explained by the Dutch mercantile policy of a one-sided movement of produce and raw materials from Indonesia to the Netherlands. In such a controlled economy, private credit demand and supply were rather limited. Transport to the harbors was partly financed by credit from the exporting firms to Chinese intermediaries, partly by Chinese internal networks. During the Cultivation System, the estates and certain processing industries obtained government credit, later bank credit which, similar to India, financed only certain sectors of the economy. In addition, most Indonesian estate production was not very capital intensive. A step toward imperialism, with foreign investment in domestic industries, as took place in India from the late nineteenth century onward, was for long delayed in Indonesia. To sum up my argument: large-scale professional moneylenders were not necessary in such an economy, because the opening-up of the private capital market was not pursued and private investment kept down for long. The liberalization of the economy, however, coincided with the institutionalization of foreign banks. Another factor was that the owners of capital in Indonesia were Chinese. In India, domestic investment was provided by various Indian entrepreneurs who had mostly been traders and intermediaries. In Indonesia, the Chinese traders had the necessary capital. But they were aliens, occupying the commercial sphere, while Indonesians tried to get a foothold in this field. Chinese were subjected to government restrictions and more or less regular pogroms before and after independence. This may explain the Chinese reluctance, until recently, to make long-term capital investments in a lucrative but very hostile environment.

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21

The Development of the Pawnshop Industry in East Asia

Michael T. Skully

While the provision of financial services, particularly loan activities, to rural areas has been a long-term goal of Asian governments, rural finance schemes have seldom met with much success. Their failure rate is such, that if markers were sited on each failed rural financial institutions or defaulting farms, the countryside would be littered with such monuments.

Of course, not all rural institutions have failed. The Grameen Bank in Bangladesh is frequently cited as a rural lending success story. Other institutions have similarly claimed success, at least for a while, but for the most part, development agencies are still seeking, like a holy grail, an institutional model that can be transposed across differing cultures and development levels, yet still achieve success.

This government bureaucrat interest is understandable, for one would always like the credit for a new institution, particularly if developed, if not run, by one's own ministry.

At the other end of the scale, the private sector has long understood rural credit, and developed appropriate vehicles to provide it. Unfortunately, as these institutions were developed by the indigenous population (not a foreign expert) and often run by private individuals with little education (not university trained bureaucrats), they were often ignored by government planners. Until recently, these institutions profited from rural lending, which also made them an unacceptable alternative to a highly subsidized government-run credit scheme.

Fortunately, the informal credit market has now become more visible and development agencies are now examining how these rural institutions operate and whether some aspects can be adapted for their purposes.

The pawnshop is one such institution in successful, very small-scale lending. For instance, as Bouman and Houtman (1988) found in Sri Lanka, when the rural branches of the People's Bank introduced pawnbroking services, they changed from losing money to making a profit. This paper, however, confines itself to East Asia and the development and operations of its pawnshop industry. In doing so, it is realized that many pawnshops, particularly in Hong Kong and Singapore, have no rural finance functions, but their experiences may nevertheless prove of interest should others wish to adapt this institution for rural purposes.

This paper will first define what constitutes a pawnshop, then consider its development within East Asia, briefly examine its operations and structure, and then comment generally on the industry's future.

Definition

While it may seem unnecessary to state the obvious, there is still a need to define one's terms. This is particularly appropriate here, as this paper considers pawnshops rather than pawnbroking, and there is an interesting, if modest, distinction.

Firstly, a pawnbroker is one that lends on the basis of collateral. Pawnbrokers differ from other secured lenders in that they take physical possession of the collateral: the items do not remain with the borrower. This is a critical distinction. When Ghate suggested that lending, where the asset pledged as collateral is left with the borrower, might be considered "a variant of pawning" (1992: 28), he missed the major difference between pawnbroking and other forms of lending. Indeed, a wider definition would effectively include most secured lending within the scope of pawnbroking; a concept that would greatly concern most bankers.

Pawnbroking also differs from most bank lending in that it is generally characterized by a very high volume of small-size advances, made for relatively short periods of time. Given the processing, valuation and storage of the pledged item, the transaction costs might appear quite high a percentage of the small amount lent. These costs, however, are partly offset in that, unlike traditional bank lending, the pawnbroker requires no credit evaluation of the borrower nor any monitoring of the loan. If the amount is not repaid when due, the pawnbroker can recover the advance with little risk or additional expense. Thus, the credit risk and associated recovery costs are largely avoided.

However, pawnbroking is not the exclusive domain of the pawnshop. Other lenders may sometime take similar collateral, like the People's Bank in Sri Lanka, as well as conduct more traditional lending. Some similarly combine pawnbroking with additional businesses. Ghate (1992: 27), for example, found that:

> In the rural areas of some countries such as the Philippines, some individuals of modest means make their living by conducting informal pawning operations combined with peddling items door-to-door that are not redeemed... while others ...combine their pawning activities with being itinerant merchants offering customers instalment arrangements.

One might well question the degree to which another business could offer pawnbroking services, compared to its other business, before it becomes a pawnbroker. In some developed countries, such as the USA, the sale of new (not just second hand) goods such as jewelry, musical instruments, and guns may constitute the major portion of modern pawnbroker operations.

It is tempting simply to resolve the matter by extending the definition to include a license. As most governments require a license, a pawnbroker could be viewed simply as an institution licensed as a pawnbroker. Such a definition would probably be quite effective in most US states, particularly those without restrictive lending policies, but it becomes less satisfactory when applied to East Asia. Pawnbroker licensing certainly exists in each country discussed, but this does not preclude other non-licensed operators from providing similar financial services. In fact, in some countries informal pawnbrokers may prove just as important, if not more important, than their licensed counterparts. Unfortunately, no statistics are available on the numbers of these informal operators or their relative size. They certainly seem important in some countries: Indonesia, where the government pawnshop service holds a legal monopoly, is the most obvious example. There, unlicensed, and hence illegal, pawnshops operate in relatively open competition, typically through gold and jewelry shops, with the government counterparts. Personal interviews suggest that these illegal operators may be several times more numerous as well as more active. A SEACEN (1986: 257) report on informal markets, for example, estimated that Indonesia's pawnshop industry was, in practice, 42 percent government and 58 percent privately run. This is despite a legal government monopoly.

Other studies, such as Bastiaanssen (1986), Bouman and Houtman (1988), Harriss (1983), Sivakumar (1978) and Wells (1980), have all found a strong presence of illegal pawnshop operators in a range of South and Southeast Asian countries. These studies confirm that a range of clients, both from high- and low-income groups, seem to prefer these unlicensed operators. The reasons are varied, but may include such factors as less formalities, more privacy, better service, higher value lent, more convenient office hours and locations and greater efficiency. As most illegal operators charge higher rates than their legal counterparts, customers apparently value these other features. Such innovations, however, are not always welcome, for these illegal operators, as others in informal finance, are subject to varying degrees of discrimination and prosecution by government authorities, politicians, the media, the clergy and, of course, the formal financial institutions. Each do so for their own reasons. Despite these difficulties, informal pawnshops continue to thrive. This suggests that their operations should receive more attention in developing country financial sector research. While this paper limits its survey to licensed pawnshops (a difficult collection task in itself), hopefully it may encourage others to examine the illegal pawnshops in more detail.

A grey area in terms of pawnbroking is the matter of the sale-buy back arrangement, sometimes offered by second-hand goods dealers or jewelers, and whether this should be considered pawnbroking. Here the answer is: it depends. If the arrangement is a formal one, with a ticket covering a specified time period and repurchase amount, the difference is almost one of semantics. The Australian state of Victoria, for instance, has actually ruled that such formal buy back arrangements constitute pawnbroking and hence are covered by the Pawnbrokers Act. Less formal arrangements, however, need not be excluded. A successful pawnbroker-customer transaction in the end relies largely on mutual trust, almost entirely so in the informal sector.

This general sale and buy back concept on which pawnbroking depends should really be restated in more financial terms. One should consider the person borrowing money from a pawnbroker, as effectively selling the item in question to the pawnbroker, in return for the cash amount of the loan, plus a call option to repurchase the item at a set price at a future date. Thus if we assume away transaction costs, the position would be as follows:

Value of pledged item = amount of loan + value of call option

As pawnbrokers are unlikely to lend the same amount as the item's value, the difference must be reflected in the *de facto* premium that the borrower is paying for this repurchase option.

The introduction of transaction costs will further reduce the amount of money lent of any specific item. As the loan processing of these costs are somewhat fixed, regardless of transaction size, one might expect they may become less important as the loan size increases. As the transaction cost would also include any storage involved, the larger the item, the larger these costs would be.

The option value or premium, as with a normal call option, would be a function of the market price of the pledged item, the repurchase price set, the option's time to maturity or repayment period, the current interest rates, and the degree of potential variance in the market price of the pledged asset. Obviously, the greater the uncertainty over the item's value when the loan is due, the greater the option's value.

Depending on the country's regulations, the item pledged, and person making the pledge, there may be other variables outside of the option premium which would further detract from the loan value. The first, and most obvious when dealing with pawnshops, is the question as to whether the pledged item is stolen. In many countries, the acceptance of stolen goods as a pledge, means that pawnbrokers may have to return the goods to their rightful owner and lose the money advanced. Another danger, though this is unlikely with an experienced appraiser, is to mis-price the value of pledged item and so lend more than the item is worth. Both risks are greatly reduced if the borrower is a regular customer, and pawnshops seem to adjust the percentage of value lent partly in line with the client's past lending history.

These same factors represent only part of the calculation for the potential borrower. As discussed earlier, a more convenient location, less formalities, greater privacy, longer office hours and other issues may be just as important as any difference in the normal interest charged.

To conclude this definitional section, pawnbroking can be conducted by a range of businesses. A pawnshop, however, can be defined as a separately constituted business (licensed or illegal) directed primarily at making a large number of small advances for relatively short periods, on the basis of the physical possession of tangible collateral. The shop may also sell unclaimed pledges (and even some new merchandise to encourage buyers) but lending dominates its overall activities.

Development

There is little question that collateral-based lending is a long-established practice. The Old Testament of the Bible, (Exodus, chapter 22, verse 25), for example, mentions taking clothing as a pledge of repayment. There are also a number of historical references to pledging goods, even slaves, as security for loans in ancient Babylon; the Greeks and Romans later developed similar practices. There are, no doubt, many other early historical lending references where the collateral was a movable item, but these transactions tended to be just one of normal money lending and other businesses rather than a specialist trade.

As to when pawnshops actually became specialist businesses in their own right, it is difficult to say. It does, however, seem that this institution is quite old and is probably older in Asia than in Europe. Within Asia, pawnshops seem to have been developed first within China and then later expanded to, or developed independently in, other Asian countries. Lien-sheng Yang (1952: 6) in his study of Chinese finance, found that the "earliest known credit institution was the pawnshop, which first appeared in Buddhist monasteries in about the fifth century". Whelan (1979: 1), similarly found evidence of these shops being very much in operation during the early days of China's Southern Ch'i dynasty (479-502 AD). In contrast, even the earliest of European specialized pawnshops were not established until after 1000 AD.

Like its later Italian counterparts, these early Chinese pawnshops had a religious connection as they were operated by monks in Buddhist monasteries. It is also worth noting that as Buddhism came to China from India via Central Asia, some scholars (Whelan 1979: 2) suggest that this institution was "a consequence of the interaction between Buddhism, newly arrived on the scene, and the rather advanced Chinese money economy."

As with the early Italian pawnshops, these monastery-run institutions were initially established not to earn money as such, but rather to benefit the poor in the monastery's local community. Indeed, when examining historical records, Chinese scholars found no interest mentioned in these early transactions: probably the increased importance of the monastery in the community's daily life and the potential of more worshippers provided more than sufficient "returns" to justify the practice. Goods were repaid in kind and later money, when lent, could also be repaid in either wheat or rice. A Chinese government civil service manual for the T'ang dynasty (618-906) similarly, when discussing pawn contracts, mentions loans without interest. This interest-free position gradually changed, just as did their Italian counterparts, and some form of interest began to be charged first to outsiders, and then local people as well.

This religious connection is interesting insofar as, while the European monasteries (particularly the Franciscans) entered pawnbroking to help the poor, they also could attack the successful money lending business run by the Jews. Even the Franciscans quickly learned that some form of interest had to be charged, if they were to continue their operations. Thus, in the process, the church, even if indirectly, took on the role of a moneylender and conducted the very practice that it itself had long condemned.

Conveniently for the Chinese monasteries, their shift toward charging interest was backed by scripture, and so the issue of usury did not present the problem in China that it did in Europe. According to Ch'en (1973: 158), the Chinese Vinaya has a passage about some merchants who left some trade goods with the monastery, and suggested the monks lend the items out for interest and so earn a profit until the merchants returned. The monks said that Budda would not let them, but they then asked him for permission all the same. Fortunately, Budda said yes and "authorized the ching-jen or pure people within the monastery grounds to carry out the commercial transactions for gain" (Ch'en 1973), with these gains used for the good of the monastery.

This early lending was rather the reverse of today's pawnshop, in that the monastery lent out the goods in question rather than received them. However, rather than relying solely on Budda to ensure repayment, the monks soon reduced the risk of this effectively unsecured lending by requiring the potential borrower to pledge other items to support the loan as well as provide third party guarantors. These pledged items could be movable such as clothing or animals, or immovable objects such as land and buildings. In the former, a loan default meant the pledged goods were forfeited. In the latter, the debtor would not lose the ownership of the property. Instead, any benefits accruing from, say farming lands, would go to the creditor. The monastery's risks were also reduced by its religious influence over the borrower and, in the case of grain or rice lending, the borrower's knowledge that he would need to borrow new seeds once again for the following season.

In time, this business side of monastery, part of the Inexhaustible Treasury, began to concentrate more on accepting goods like a modern pawnshop, or for safe keeping. Its success also attracted unlicensed private sector imitators and, according to Whelan (1979: 1) by the time of the T'ang dynasty, 618-906 AD, independent pawnshops, operating outside the monastery, were well established. Interestingly, these new operators continued to dress in black gowns not unlike the monks, but required money for redeeming goods. By the Ming dynasty (1368-1644 AD), however, the monastery pawnshops had all but disappeared. An obvious connection is the decline in importance of Buddhism over this period, but it is also likely that the private sector simply provided better service and were better funded. This may also be reflected in the fact that the practice of wearing black gowns, once a symbol of the former monastery connection, had also ceased: the facade of a monastery connection had apparently become a disadvantage. In contrast, private pawnshops flourished, and as Lien-sheng Yang (1952: 6) commented, by the time of the Ming dynasty (1366-1644) "one or more pawnshops would be found in every city and town and in many villages". By the early 1800s China had some 25,000 pawnshops.

Well before the 1800s, though, pawnshops were already well established elsewhere in Asia. Most of these have a definite Chinese connection, with Chinese or ethnically Chinese merchants establishing or at least dominating the local business; a position that is still largely the case in Malaysia, Singapore and Thailand. The one exception was Japan, where a similar but somewhat differently based industry developed.

Whelan (1979: 3) found Japanese pawnshops date from the Kamakura period (1185-1333 AD). They were certainly very important institutions by the 1600s. Sheldon (1958: 58), for example, found that problems with pawnshops and stolen goods caused local pawnbrokers to establish chartered trade associations (*kabu nakama*) in Osaka, Edo and Kyoto in 1642, 1692 and 1699 respectively, to assist the police in tracing stolen goods. This Japanese business could have also developed from a temple base and may well similarly have a Chinese Buddhism connection, but Japanese pawnshop owners, when interviewed, were quite upset over this suggestion. Their version is rather more interesting, but as with the Chinese, is a rice based story. In Japan, saké was, and in many cases still is, the dominate drink, and its production is very important in the local economy. To ensure sufficient raw materials, saké brewers had to ensure a good rice crop and so provided local farmers with sufficient seed. They were repaid in kind, but with more rice then they lent. Like the temples, the brewers began to deal in other items, and gradually a cash business developed.

Many of these early saké based pawnbrokers soon expanded into other businesses and eventually became very important forces within the Japanese economy. Sheldon (1958: 64) found that Mitsui traces its establishment to Matsuzaka in Ises province, where it commenced brewing saké, operating a pawnshop and lending money around 1620.

The Japanese brewer/pawnbroker seemed quite content to stay at home, and it was left for Chinese merchants to introduce pawnshops to the rest of Asia. In the days of smaller independent states, local rulers were eager for additional sources of funds, and Chinese businessmen were pleased to assist. Just as a farmer might rent some land and then cover the rental from the crops it produced, businessmen might also rent an exclusive franchise for a certain business within a specific town or area and then keep any profit that might result. This so called "farming" was profitably applied to a range of businesses to include gambling, opium, and liquor sales as well as pawnshops. In most cases, Chinese not only rented the "farm," but were also its farmers; there seems little evidence of ethnic Malays or other indigenous people acting as pawnbrokers.

It is not known when pawn "farming" began, but was certainly well established by Malay rulers long before the Europeans arrived, and the practice was seemingly followed in Indonesia, Thailand and probably the Philippines as well.

While initially the European powers, on arrival, usually adopted a similar approach, some found the Chinese pawnbrokers overly aggressive in their "farming" and the local people complained accordingly. Thus Emery (1970: 210) found that, as early as August 20, 1746, the Dutch had established their own pawnshop, the Bank van Lening, in Batavia to give the Chinese shops some price competition.

The British, however, had no such difficulty in accepting "farming" rents and when T.S. Raffles arrived in 1811 to administer England's brief rule of Indonesia, he closed the government pawnshop and by 1814 had reintroduced pawn farming. He similarly supported "farming" while in Singapore, for Buckley (1984: 114) found that on June 6, 1823, as Lieutenant Governor, Raffles proclaimed that:

> Pawnshops should be placed under specific regulations, and none allowed to act as such without giving security for complying with the same and taking out a license for that purpose.

Table 1: Beginning of Pawnshops in Asia

Country	*Beginning of Pawnshops*
Chinabefore	479-502 AD
Hong Kong	before 1800
Indonesia	before 1746
Japan	1600s
Malaysia	before 1811
Philippines	before 1860
Singapore	before 1811
Taiwan	unknown
Thailand	before 1741

Pawnbroking, however, did not prove as profitable as Raffles' other "farming", for, by May 1824, it had earned the government only $480 compared with $26,112 for gambling, $23,100 for opium, and $10,980 for spirits.

By the 1800s, there is ample proof of pawnshops operating throughout Asia. The oldest known licensed pawnshop in Thailand, the Jek Heng, was established in 1866 (BE 2409) on Bamrung Muang Road; while now known as the Yong Heong, a pawnshop still operates on this site. Similarly, the oldest known pawnshop in Hong Kong, the Chun Yuen Pawnshop in Yuen Long village, for example, was founded around 1800. In both cases, however, the local industry is undoubtedly much older.

A comparison of these various "establishment" dates, and some even rougher guesstimates for the other countries, is provided in Table 1. However, as these dates represent the earliest reference to local pawnshops, local informal operations probably started considerably earlier. Probably, the start of significant Chinese trade and a local expatriate Chinese merchant population, would mark the commencement of the pawnshop business in each country. The licensing of pawnshops would have been much later and many unlicensed operators continued business outside the regulations.

In most cases, to include Indonesia, Japan, Malaysia, Philippines, Singapore and Thailand, these first pawnshop references were not favorable ones. Instead, they relate to government dissatisfaction with the rates charged or practices followed, and attempts to correct the problem. For example, in Thailand, Porntip (1981: 26) found the first reference was in a Royal Decree by King Maha Thammathiraj in 1741 (BE 2284): it indicated that stolen goods must not be pawned or sold, and placed the responsibility to obtain proper proof of ownership on the lender-buyer. In contrast, in Japan one of the first references in the 1600s was to the industry itself, by forming local trade associations, trying to address the same stolen goods problem. The first Indonesian reference in 1746 was to Dutch Colonial administration's attempt to solve perceived usury problems by, as in Holland itself, establishing what became a wholly public sector run institution.

Though Asia's first experiment with a government pawnshop ceased with the British control of Indonesia, the concept was certainly considered appropriate, and was later followed by the Spanish Colonial government in Manila. According to Blair and Robertson (1973: 216), it established its own operation on January 18, 1860, to compete against private pawnshops, again with the hope of reducing interest rates.

Once again in Dutch hands, Indonesia then tried to address the high rates problems through greater government controls. In 1849, for example, a licensing system was introduced, through which existing pawn "farmers" could gain a legal monopoly for their area in return for following an interest rate schedule. Unfortunately, the schedule was often ignored and the Dutch returned to their initial solution, and, like the Spanish, established a government pawnshop providing more socially accepted rates of interest. Established as an experiment in 1901, the business in Soekaboemi proved a success and justified an additional shop in Tjianjoer (Candoer) in 1902. A government pawnshop service was established accordingly and it gradually expanded, replacing the privately owned pawnshops, until the entire industry became government owned.

Interestingly, Thailand addressed this interest rate problem in much the same fashion. First, it attempted regulatory controls with the Pawnshops Act of 1901 (BE 2444), but, eventually, it established public sector institutions, too. However, unlike the Dutch, it not only allowed the private sector to continue, but also established two types of public sector pawnshops: those run by the Federal government and those run by municipal governments. While both public institutions follow the same interest rates and lending guidelines, their operational style is quite different. The Federal shops are run as business enterprises, with the employees privately hired workers rather than public civil servants. They receive some budget funding, as well as being able to borrow from the Government Savings Bank, and other institutions. In contrast, the municipal government pawnshops are operated by civil servants and funded mainly by their respective local government.

Other countries, such as Japan, have also experimented briefly with government-owned pawnshops in a

Table 2: Licensed Pawnshop Ownership in Asia: Private or Government

Country	*Type of Licensed Owners*
China	private and cooperative
Hong Kong	private
Indonesia	government monopoly
Japan	private
Malaysia	private
Philippines	private
Singapore	private
Taiwan	private and some government
Thailand	government and private

similar attempt to provide lower cost credit to the poor. Today, as shown in Table 2, only Indonesia has retained a public sector monopoly of the business. This monopoly, however, is only a notional one, for as mentioned earlier, an active, illegal private pawnshop industry is very much in evidence.

It is difficult to judge as to the relative success of public versus private ownership within the pawnshop industry. There are relatively few operational statistics to compare. Even where statistics are available, they tell only part of the story. Unlicensed, illegal pawnshops may be just as important as their licensed counterparts.

Through their respective licensing agencies, the number of licensed pawnshops can be obtained for most countries. Perhaps not surprisingly, there appears a direct correlation between the number of licensed pawnshops operating within a country and the degree or level at which that country regulates interest charges. Looking first at the lending rates, generally with the maximum set by the government, shown in Table 3, it is clear that Singapore and Malaysian pawnbrokers would appear worse off. In contrast, the pawnshops in Japan and Taiwan appear the best placed, as their interest ceilings are relatively high. While no current rates are available for the Philippines, the general deregulation of interest rate controls in that country suggests that pawnbrokers may be largely free to charge whatever they wish. Of course, one could argue that pawnbrokers have this freedom in any case, for when the legal rates prove too restrictive, some operators may decide to risk operating outside the legal sector. While it would be wrong to claim a direct cause and effect relationship

Table 3: Pawnshops in Asia: Interest Rates Charged

Country	*Interest Rate*
China	4.5 to 5.2% per month
Hong Kong	3.5% simple interest per lunar month
Indonesia	3.0% per month (<Rp.20,000) or 4% per month (>Rp.20,000)
Japan	4.0 to 8.0% per month; varies with amount and locality
Malaysia	2.0% per month maximum
Philippines	unknown
Singapore	1.5% per month
Taiwan	3.6% per month (govt.) or 9% per month (private)
Thailand	up to 2.0% per month (govt.)

Table 4: Licensed Pawnshop Numbers in Asian Countries

Country	*Number of Pawnshops*
China	200 (estimation per mid 1991)
Hong Kong	173 (early 1990)
Indonesia	505 (end of 1990)
Japan	6,577 (March 1991)
Malaysia	194 (end of 1991)
Philippines	1,824 (end of 1990)
Singapore	60 (end of 1991)
Taiwan	1,137 (mid 1991)
Thailand	361 (end of 1990)

Table 5: Pawnshops in Asia: Types of Regulators

Country	*Type of Regulator*
China	unknown
Hong Kong	Commissioner of Police
Indonesia	Domestic Monetary Affairs Office, Ministry of Finance
Japan	Department of Police
Malaysia	Ministry of Local Government and Housing
Philippines	Central Bank of the Philippines
Singapore	Ministry of Social Affairs
Taiwan	National Police Administration, Ministry of Interior
Thailand	Police Department, Ministry of Interior

between these rates and the pawnshop numbers per country, shown in Table 4, one cannot help noting that Japan has more licensed pawnshops than any other country, and is followed by the Philippines and then Taiwan. The overall position, if one includes the illegal pawnshops operating in each country, might be quite different. Indonesia, in particular, would rank much higher, possibly first place.

In contrast to the interest rate levels, there seems no direct relationship between the type of regulatory agency selected for the industry and pawnshop performance. What is worth noting, is the close relationship between the police department and the pawnshops. This is a function of the stolen goods problem raised earlier. As a result of the close connection with the police (regardless of regulator shown in Table 5), stolen goods today are seemingly not a major issue within the industry or its respective government: it seems a matter addressed adequately by the pawnshops and the police themselves. Another point about this police connection is that, with the exception of Indonesia, Thailand and the Philippines, pawnshops are often forgotten institutions in terms of government financial sector reports.

Before closing this section of regional comparisons, a few other tables may also prove of interest. For example, as shown in Table 6, there are major differences in the types of goods that pawnshops accept. Those in less developed countries, such as Indonesia, accept a wide range of consumer goods. A visit to a provincial pawnshop office there, will find the store rooms crammed with bicycles, kitchen ware, furniture and *batik* clothing. In contrast, those in Singapore deal almost exclusively in gold, mainly as rings and chains, as well as other jewelry. While it varies on the shop's location, as well as the country, most pawnshops are also still generally happy to accept expensive cameras, watches and pens. The key item pawned, and this is common throughout South Asia as well as East Asia, is gold jewelry. The desire by most Asians, regardless of country, to hold some of their assets in gold jewelry, may be a major reason for the industry's success. The Asian preference for relatively pure gold, usually at least 24 carat, has also helped, and continues to a large extent, to help ensure the industry a regular source of business. As Lamberte (1988: 1) explains:

> Our parents (in the Philippines) used to tell us: the moment you start earning, buy some jewellery and other properties. You can pawn them whenever you encounter financial difficulties.

While few Australians or Americans would choose gold jewelry as a significant form of investment, a history of hyper-inflation, wars and political uncertainty, have caused many Asians to value an investment that is highly

Table 6: Common Pawnshops Pledges in Asia

Country	*Pledges*
China	jewelry, classic Chinese calligraphy, electric appliances, antiques, bicycles, watches and expensive clothing items
Hong Kong	gold jewelry (particularly rings and chains), watches, other jewelry, some consumer goods if located in housing estates
Indonesia	bicycles, TVs, kitchenware and other household goods, batik, gold, other jewelry, and other valuables
Japan	jewelry, gold, some watches, electrical goods, cameras, expensive kimono and other clothing
Malaysia	gold and other jewelry items
Philippines	gold and other jewelry
Singapore	gold and other jewelry items
Thailand	gold, other jewelry, watches, TVs, VCRs, radios, and other electronic goods

Table 7: Pawnshop in Asia: Percentage of Value Lent

Country	*Percentage of Value Lent*
China	50 to 80% of value
Hong Kong[a]	40 to 60%
Indonesia	84% (<Rp.20,000) or 89% (>Rp.20,000)
Japan	to 80% jewelry, to 20% used goods
Malaysia	to 60% on jewelry
Philippines[b]	at least 30% of value
Singapore	80 to 85% on gold jewelry
Taiwan	unknown
Thailand	75 to 85% for gold jewelry

[a] Sometimes up to 70 to 80 percent for established customers.
[b] The minimum percentage is set by government regulation.

liquid, of high value compared to its size, and easy both to move and conceal. Gold jewelry also has the added advantage of providing some enjoyment, and in some cultures added status, to the wearer. Pawnshops also enhance the attraction of gold ownership. As the Asian Development Bank (1990: 192) pointed out:

> Pawnshops (and buy-back practices by jewelers) play a crucial role in conferring liquidity upon the precious metals and ornaments which have traditionally been one of the main asset forms in which households have invested their savings in a number of Asian countries.

The pawnshops themselves, of course, have an understandable preference for gold items. Firstly, gold is easily resold and there is potentially relatively little delay in realizing the collateral, should the borrower not redeem the pledge. Gold also has an advantage in that its purity can be easily determined and, so the risk of mis-pricing the collateral is substantially less than with a camera or other item of value. Finally, gold jewelry typically takes up very little room and so causes the pawnshop little storage costs. As a result of these factors, the highest percentage figures of value lent shown in Table 7 are for when the borrower pawns a gold item.

The Future

Given the centuries of bad press that pawnshops commonly receive, at least within the English language world, one might expect that their days are numbered. As governments become more concerned with the interest rates charged, their response might well see these institutions legislated out of business. Strangely enough, the public does not seem to share the official attitude that is often inspired by a political or religious stance against high interest rates. Fortunately, most regulators have finally learned the lesson of price controls and market forces. An industry forced to operate at sub-market prices will simply be replaced by a new institution, commonly one outside of regulatory control. The more restrictive the regime, the larger and more important this unlicensed sector will become. Indeed, unlicensed businesses sometimes flourish side by side with the regulated ones. A similar response to over-regulation, is to conduct pawnbroking through an allied business such as a jewelry shop or second-hand goods store. Therefore, depending on the local regulators, this pawnbroking sideline can be conducted either openly, or under the counter.

On the other side, concern that deregulation of the banking and other financial institutions will bring an end to the industry, is also probably unfounded. For example, one might have expected this to have happened in the United States where the pawnshops were in any case suffering a decline due to the rapid growth of other forms of consumer credit. Ironically, bank deregulation, in particular, has brought with it an almost boom period for American pawnshops. As deregulation caused the banks to introduce a user pay approach toward their retail accounts, and to tighten their lending standards, many lower income customers found the new fees made their bank accounts uneconomic to maintain. Similarly, their access to credit cards and other consumer loans had become both more limited and more expensive. Thus, for many Americans, the speed with which a transaction can be completed, the lack of problems over a bad credit history or employment record, and the hassles from debt collectors with non-payment, coupled with being able to borrow really quite small amounts of money for short periods, have caused a major shift in USA pawnshop business. As Caskey (1991) discovered, it is no longer the domain of gamblers and small, old downtown operations, but has become instead more that of middle class Americans dealing with large, modern pawnshops in shopping malls. These more recent entries may also be part of a growing network of regional and national chains of pawnshops (such as Cash America, Ezcorp, and US Pawn) which sell new jewelry and other items as well as unclaimed pledges -- in support of their lending activities.

In conclusion, pawnshops play an important role in providing consumers a quick and convenient source of loan funds. While these offices are located mainly in towns rather than villages, they use agents to operate in the countryside on their behalf. Therefore, pawnshops in developing countries service a wide range of people including those from the rural sector and even petty traders and other small-scale entrepreneurs. Unlike many government-sponsored small loan schemes, they seem successful in providing their customers small, short-term loans with relatively little loss problems, and generally earn a sizeable profit. Pawnshops have already been used with some success by the public sector in Sri Lanka, Indonesia, and Thailand. Government planners in other developing countries may wish to consider how these institutions or their lending methods, either as regulated private or public sector bodies, could be used more effectively to finance rural development within their countries.

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22

ROSCA and ASCRA: Beyond the Financial Landscape

F.J.A. Bouman

There are numerous self-help groups in low-income countries. They have three main functions: security or insurance, economic, and socializing. The (social) security function covers rites of passage, life cycle events, spiritual and religious ceremonies and education. Voluntary associations insure members and their next of kin against the consequences of illness, accident, death and other possible mishaps. The economic function is apparent in the provision of safekeeping facilities and loans, in collective investments and community development works, such as construction of roads and bridges. The socializing function may be best expressed by the concept of "togetherness": meeting, discussing, eating and drinking together, and taking part in recreational activities like sports, singing, dancing, even politics. Financial services form an important part of all these functions. Even the masquerade group in Benin, the football club in Kenya and the political party in India may give loans to members from contributions collected.

Africa is particularly noted for its proliferation of those groups that have saving and lending as a main or auxiliary activity. This chapter briefly compares two basic forms, Rotating and Accumulating Savings and Credit Associations. Of the two, the ROSCA has attracted most attention from researchers. Information on the second type is urgently needed, because they seem to grow in number and importance. This chapter fills only part of this gap.

My main purpose is to demonstrate, through case studies of Cameroon, Senegal and Nigeria, the amazing ability of financial self-help groups to adapt to a changing environment. An evolutionary analysis reveals changes in the broader context of the economic, social and political arenas of these countries. Study of the evolution of financial mutual aid societies in context can thus open new avenues for fruitful exploration.

ROSCA and ASCRA Compared

Financial self-help associations that have saving and lending as a primary or sole function, are found in two basic forms, Rotating and Accumulating Savings and Credit Associations, ROSCA and ASCRA for short. There is one marked difference between the two types. In the ROSCA, each time that savings are pooled, they are immediately redistributed among members in rotation, until each has had his turn and the ROSCA comes to an end. Its lifetime depends on the number of players and the periodicity of contribution; 40 participants making weekly payments means a lifetime of 40 weeks, a ROSCA of 12 players and monthly payments lasts one year. The "instant" redistribution avoids the need for safekeeping of funds. In principle, each participant draws from the ROSCA as much as he puts into it. The main advantage is that each member, except the last recipient, will reach his goal sooner than when acting on his own, because he is getting a loan from all other members. This is most clear in a ROSCA in which all members are saving for the same item, e.g. a sewing machine of US$120. Saving $10 a month individually, it would take one year to accumulate the necessary $120. In a 12-member ROSCA, all players, except the last recipient would be in possession of the sewing machine earlier, lucky number one already after one month.

The loan in the ROSCA is automatic, as is its repayment; there is hardly any administration. The ROSCA represents the most simple and straightforward form of financial intermediation, although there is a growing number of sophisticated variations on the original scheme (cf. Bouman 1977).

The ASCRA, on the other hand, resembles the Credit Union. The pooled savings are kept in custody and accumulated for a specified time, at the end of which the savings are redistributed. The common period is here also one year, during which members may save to pay taxes and school fees or to meet the expenses of a recurring festival or religious ceremony, like the Chinese New Year, Christmas, or Diwali, a Hindu festival in India. Participants might also build up a fund to pay for emergencies, insurance, community development expenses or for joint investment. In fact, any individual or common purpose will do.

Meanwhile it is usual – with a few exceptions – that loans from the fund are made. Lending becomes the preferable strategy in an expanding economy and consumers' market. High interest on loans – 5 to 10 percent a month being not uncommon – make the fund accumulate very fast, thereby increasing not only the opportunity for borrowing, but also the value of members' savings. Participants might agree to save equal amounts regularly on a contractual basis or to make voluntary, unequal and irregular payments. They might also agree to extend the accumulation process over a long time, as in the five-year *Bishi* in Sangli; or to distribute only part of the money and aim for a more permanent fund, so that borrowers can take more and longer-term loans.

However, this increases the risks of safekeeping, loan defaults, plus increasing administration and transaction costs.

Unlike in the ROSCA, loans in an ASCRA are not automatic, but subject to loan decision by a board or the consent of members, and arrangements for repayment should be made. Possibly, collateral may be required. Loan administration typically is extensive, necessitating the need to keep records.

ASCRAs are much larger than ROSCAs; membership may number several hundred, even a few thousand, while a ROSCA usually numbers between 12 and 50, depending whether meetings are monthly or weekly. A larger ROSCA would result in a longer cycle, with the opposite effect to its very purpose: accelerated access to capital or a commodity. The ROSCA loans are automatic and the group has to be kept small and localized, because much depends on mutual trust and knowledge of each other. In this respect, the ROSCA is like the credit cooperative of Raiffeisen, who also wanted to keep the cooperative small and localized because of the principle of unlimited liability.

Outstanding Institutional Characteristics

Besides exhibiting their own peculiarities, ROSCA and ASCRA have a number of characteristics in common. The most notable one is that both are autonomous institutions, for and by the common and not-so-common man. This fact is often overlooked by development agencies, eager to introduce their own models of "participatory democracy" in an alien culture.

In both ROSCA and ASCRA participation is voluntary. As financial institutions, they exhibit a degree of self-sufficiency, self-regulation and self-control that is exemplary. Assistance and control by official authorities are not appreciated nor necessary, impede the institution's flexibility and adaptation to members' priorities and the environment. The criticism that ROSCA and most ASCRA lack permanency because of their short life cycles is true, but without much meaning on close scrutiny. Permanency runs counter to the ROSCA's very purpose of quick access to a lump sum of money and its adaptation to change.

And is permanency of particular value per se? Permanent institutions have a proven penchant for increased formalization and bureaucracy. The struggle for leadership and status often becomes fierce. Once installed, boards and staff tend to entrench themselves and oppose changes in rules, procedures and strategy. In ROSCA and ASCRA it is precisely the short life cycle that enables the members to include or exclude whoever they wish, even depose board and staff at the end of an old and the beginning of a new cycle.

These financial self-help groups have their own particular brand of permanency by re-instituting themselves after each cycle ends. Participants are thus in a position to continuously change the financial technology of their society. They can quickly meet a change in the socio-economic climate, such as a boom or depression, inflation, a change in monetary policy or national legislation and efforts at control. It is precisely the non-permanency that permits the ROSCA and ASCRA to adopt a new strategy to fit the circumstances. They can do that as a self-regulating mechanism; they are both product and producer of change (cf. Hospes 1992: 383).

As we shall see shortly, the short life cycle offers the perfect climate to enable regular adaptation of the ROSCA's most crucial feature, the rotation of the fund. Over and above seniority and status as main criteria, priority is given to consensus, need, lottery or auction. This has everything to do with changes in status and power of village elites, with rural exodus and urbanization, education of the young and changes in the economic and political climate. In the end, we seem to observe an increasing tendency to combine ROSCAs with elements of ASCRAs in some kind of hybrid form of financial self-help group – as in the following African case studies.

Case Studies from Africa

The *Tontine* in Francophone and *Esusu* in Anglophone West Africa belong to the most versatile and intriguing financial self-help associations in the world. To a large extent the *Tontine* has gained its fame in literature from studies of the Bamilike in Northwest Cameroon, the *Esusu* from research among the Ibo in Southeast Nigeria. It seems not by accident that these two ethnic groups are among the more enterprising and industrious people of Africa, whose rise to economic prominence has drawn global scholarly attention. The *Tontine*, in particular, has played an important part in this rapid economic ascent, challenging the view of the ROSCA as an adaptation to poverty. Like the *Stokvel* in South Africa and the *Bishi* in India, both *Tontine* and *Esusu* are collective names, comprising both ROSCA- and ASCRA-types of organization.

The Tontine in Cameroon

Laffite (1981) describes the *Tontine* as a model of financial mutual aid, with four types of activities. One is the social security fund for emergencies and life cycle events, with irregular *ad hoc* contributions at the moment the need for support arises. The second is the familiar ROSCA. The third is the "bank", an ASCRA-type of fund, with contributions separate from the ROSCA or drawn from the ROSCA fund of a winning member. Interest rates on loans are 10 percent a month. Savings plus interests are redistributed after certain intervals to cover specific expenses (festivals, ceremonies, schoolfees). It has become customary to leave part of the capital in the "bank" to give it a more permanent character, indicating the growing need for continuity in lending. The fourth activity is that of collective investment, with profits accruing to members. Examples are a taxi, a bar or restaurant, houses, a community hall, a hearse (the latter three for rental purposes). Women have their own investment projects such as the cornmills in Cameroon. The ROSCA and the collective investments, are the main forces behind the economic powerbase of the Bamilike.

Not all *Tontines* perform all or even the same functions. There is a large variety of different *Tontines*, confusing the observer not familiar with local idioms. The name *Tontine*, dating from the seventeenth century after the Italian Tonti[1], is obviously foreign to indigenous Africa. In a personal letter of November 1991, van Dievoet and Verboven refer to this confusion by remarking that "if one finds two Cameroonians together, you may already have a *Tontine*." By looking for local idioms they succeeded in identifying among the Bamilike: (1) the *Ntshwa*, a ROSCA with all its familiar variations for rotation of the fund, (2) the *Lung* or "Bank", of more recent origin, which is an ASCRA with annual disbursement of savings, accumulated fines and interests on loans, (3) "*associations tontinées*" (no local idiom given) in which people can save for a particular purpose such as school-fees and taxes, but also for development projects and insurance schemes, and (4) the *Ma'agwa*, an emergency fund to help members in distress and to which the rich contribute more than the poor. The authors argue that the *Ma'agwa* is one of the oldest examples of mutual aid and forms the basis of the *Tontine*. Nowadays it is also used for life-cycle events such as birth and marriage, and payments take the form of a cheaply priced loan rather than a gift (Dievoet and Verboven 1991: 11-16). These observations are identical to those of Laffite ten years earlier. The trend toward a hybrid institution, mixing rotation and accumulation of funds and a more economic use of funds, is clearly visible.

The Tontine as a Multi-Functional Institution

In much of the literature on Francophone West Africa the *Tontine* appears as a ROSCA with little attention to its other functions. Perhaps this is due to a preoccupation with the astounding economic performance of the Bamilike[2]. In more recent literature the *Tontine* is shown as a multi-functional self-help institution, with the emphasis now on the ROSCA, then on mutual aid or collective investment, then on community development in the city or village. Especially in the urban environment the *Tontine* appears in its most elaborate form of insurance agent, financial intermediary and promoter of community development, and a clearing point for information on many issues. It supplies migrants with a point of stability and a means of integration between traditional and modern structures, between village and urban lifestyles.

According to Sidman-Steiner, who spent most of her research in Douala, Cameroon's second largest city, "thousands of women, young people and unemployed, could not survive without their *Tontine*" (Sidman-Steiner 1983: 9). Membership of urban *Tontines* is a must for rural migrants – even after death. It is imperative that the dead be buried in their home village, to join the spirits of the ancestors. Funeral costs – casket and its transport by lorry to the village – may easily run into the equivalent of several hundreds of US dollars. These costs, like hospital expenses and those of other misfortune, are borne by the *Tontine*, to which every migrant has to contribute on penalty of ostracism and loss of the right to burial in ancestral soil. No wonder that practically all migrants in the city belong to *Tontines*, organized per village or region in subsections, often each with their own uniform.

1. Cf. the *Concise Oxford Dictionary*: "Tontine (It. tontina), Lorenzo Tonti originator of tontines about 1653. Annuity shared by subscribers to loan, the shares increasing as subscribers die till last survivor gets all". Particularly the "last survivor gets all" has inspired many exciting tales of greed, murder and horror by fiction writers. Shanmugan, however, consulting the *Enciclopedia Italiana*, pictures a more conservative Tonti, a Neapolitan banker (1630-1695) whose "devise was more of an insurance scheme involving state participation. The scheme subsequently failed" (Shanmugan 1989: 351).
2. Rowlands observes how the entrepreneurial skills and economic power of the Bamilike are seen as a threat to the political future of the state, whose centralized planning has failed. "The current banking crisis in Cameroon is widely attributed in public folklore to the Bamilike and Bamenda having withdrawn all their savings in the face of loss of foreign banking support" (Rowlands, 1993).

The Tontine in Senegal

Recent publications on Senegal confirm the changing role of financial self-help societies in West Africa (Dupuy 1991; Dupuy and Servet 1987). Like other countries, Senegal is confronted with a deteriorating economy, a banking crisis, a rural exodus of gigantic proportions, and rapid urbanization. The country has a centrally planned administration that is slowly disintegrating in the face of ethnic conflicts and widespread corruption, and is unable to provide basic public services.

In this climate we witness a revitalization and re-orientation of traditional systems of mutual help, based on the village association and associative saving. The village association not only exists in the village where it traditionally takes care of communal welfare, but, paradoxically, also in the cities where it is modelled by rural migrants after the parent organization back home. “In each metropolitan area where migrants are to be found there is a multitude of village associations representing all the points from which the migrants have been drawn” (Dupuy 1991: 5).

The urban village association, to whom more than 80 percent of both male and female migrants belong, collects contributions for a twofold function. One function is a social security system for the migrant community itself, whose funds might also be used for joint investment projects. The other is to provide a mechanism for investing in their village of origin, mainly in infrastructural facilities, vital to its development, and from which their kin – and they themselves after retirement and homecoming – may reap the benefits. They may thus help stem the tide of the rural exodus.

According to Dupuy and Servet, the village association is different from the *Tontine*. But the scenario they paint closely resembles that of Laffite, Sidman-Steiner, and Dievoet and Verboven. The village association in Senegal, like the *Tontine* in Cameroon, has taken over from a helpless, bankrupt state responsibilities in the area of social security, resource redistribution and infrastructural facilities (Dupuy 1991: 2). Basic to the village association are “associative savings”, which, Dupuy argues, “have remained unnoticed for a considerable time because they are easily overlooked by an observer” and should not be confused with *Tontine* savings (Dupuy 1991: 12). The *Tontine* is part of the commercial economy and promotes the welfare of the individual, while the village association is part of the public economy and subordinates individual success to collective success (Dupuy 1991: 16). This view limits the *Tontine* to a mere ROSCA.

However, “associative savings” have certainly not been overlooked by observers of Africa as Dupuy argues. The collection of money by urban migrants to be spent on amenities “back home” have been reported by Kenneth (1957), Ezeabasili (1960), Katzin (1964), Uchendu (1966), Ottenberg (1969), Nwabughuogu (1984) and Jellicoe (1968).

The assertion of Dupuy and Servet that associative savings are used to promote the collective and not the individual welfare, needs closer scrutiny. It strikes me that the authors make no mention of loan operations of the village association. This makes one wonder what happens to the funds after accumulation in the city and before transfer to the annual village congress, when the migrants go home to help in the fields and co-decide with the villagers on present and future improvements. It is difficult to imagine that in an economy where money is a scarce good, the (urban) village funds remain unused during the process of accumulation. They might be deposited with a bank, but people have lost faith in the crumbling banking system (cf. also Aforka on page 385-86). Is it not more likely that at least a part of these funds are loaned to members or even to outsiders, against a healthy rate of interest? Dupuy herself mentions that “to a certain degree and in the case of certain associations, the fund may also be used to finance industrial projects set up by certain members” (Dupuy 1991: 7). The author does not specify whether this is in the form of a loan or not.

These “industrial projects” seem, however, consistent with the uses of the “*Lung*” or bank, and those of the “*associations tontinées*” (Dievoet and Verboven 1991), and the collective investments mentioned by Laffite (1981). The cornmill societies I came across in Northwest Cameroon in conjunction with a *Njanggi* – the local ROSCA – might be put in the same category. During accumulation, available funds were loaned to promote the welfare of (groups of) individuals.

There may be, after all, not that much difference between the urban *Tontine* of Cameroon and Dupuy’s “village associations” of Senegal. In both cases, there is the picture of an institution covering a range of individual and collective activities. The confusion may well be due to a too liberal use of the name *Tontine* in the literature. Dupuy tries to redress this by making an explicit distinction between institutions serving traditional and modern society (1991: 16) on lines analogous to Tönnies distinction between *Gemeinschaft* and *Gesellschaft*.

Financial Self-Help Associations and Village Improvement Societies in Nigeria

Much literature deals with the Ibo of Nigeria, where these improvement societies come by many different names, cut across village-boundaries and are linked into regional and national unions. The sums collected are huge. “One observer claims that he saw an up-country union raise in six hours and in a single meeting over £16,000” (Little 1957: 587), a tremendous sum in the 1950s.

Migrants in places as far away as London, Paris or New York still contribute to their ethnic unions, for public sector investments in their native villages in many countries of Africa. A Nigerian colleague, who is a Yoruba and lectures at Kano University in Kano State, makes monthly contributions to the improvement society of his home town Tede in Oyo State. Amongst the completed projects are a secondary school, a post office, a maternity clinic and electrification of the town, the latter with a 30 percent government subsidy. “Every migrant, male or female wherever he migrated to, is under a moral obligation to contribute according to his financial position. If he does not, his family will be shamed and will pay instead” (Julius Falola, p.c. September 1992).

Women might have their own separate societies, and unions might associate for industrial purposes, like the *Tontine* women in Cameroon. In Southern Nigeria women’s societies run a bakery, a laundry, a calabash manufactory and a gary mill (Little 1957: 585).

Financial Self-Help Groups in Historical Perspective

Despite the fact that many researchers report the existence of village improvement societies in Nigeria, there are few historical accounts of the financial self-help associations and the relation between these associations and the improvement societies. Ottenberg’s research among the Ibo in the Afikpo Division (East Central State; now Abiya State) in the 1950s goes back to the beginning of this century. Accumulation of savings was in kind and largely spent on ritual ceremonies, life cycle events and the acquisition of titles[3] and took place through the secret societies and the title societies that were traditionally dominated by the village elders.

Great changes, however, occurred with the gradual evolution of Afikpo towards a market economy, and the introduction of money. From the late 1940s, “progressive” youngsters with urban experience started loan societies and village improvement unions for community projects and scholarships (Ottenberg 1968: 242). It was the young villagers who became members and paid contributions. The older generation, who were felt to have misused the title societies for their own benefit, were kept at bay as much as possible.

The unions’ greatest attraction was that they gave loans, once a year, at the annual meeting, to be repaid at the next meeting with 25 percent interest. The popularity of the loan associations became such, that some 250 societies were established in the 22 villages of the Afikpo Division (population 30,000) since 1940 (Ottenberg 1968: 245). A young man had now four loan sources at his disposal: the village unions, the loan associations and his lineage groups and age sets. Village elders were still not very welcome, because the young feared they would use the loans unproductively for traditional rituals and the buying of titles.

The young, on the other hand, used the money to go into trade or for growing new crops for the market. Loans for education were also popular. The associations had enough money to satisfy almost all loan demands. Repayment seldom caused trouble, conditions being very lenient. The Ibo Tribal Union functioned as the national umbrella organization, to which practically every Ibo belongs, wherever he migrated to.

It is clear from Ottenberg’s discussion that the loans of the different societies are of the ASCRA type. In fact – and this is surprising – he emphasizes “the lack of a system of rotation of loans so common elsewhere”, referring to Ardener and Bascom (Ottenberg 1968: 246). He relates this to the “high sense of social solidarity among the group’s members” (Ottenberg 1968: 247) as if rotation, by itself, will disturb solidarity. The Afikpo Ibo are, of course, already familiar with the rotation principle in their rotating labor parties.

Not much later, however, the ROSCA does appear in the Afikpo Division in a study by Okorie and Miller of three villages in 1975. Using the well-known idiom *Esusu* for both the ASCRA- and ROSCA-type of savings and loan associations – an idiom that is absent from Ottenberg’s paper – the authors locate 15 ASCRAs, 7 ROSCAs and 3 hybrids, ROSCAs with an additional cumulative fund for loans. Four clubs handle community improvement projects as a side activity. The historical record shows that “only four of the 25 clubs had been in existence over ten years and only one for over 20 years” (Okorie and Miller 1976: 10).

What about the introduction and evolution of ROSCA, ASCRA and “improvement unions” elsewhere in Nigeria? Ardener reports the existence of ROSCA among the Ibo already in 1953; Uchendu, making his studies in the very proximity of Afikpo in 1966 implies that the *Ogbo* clubs, the local Ibo idiom, have a long history (Uchendu 1966: 78-80), stating that it was common to combine in the *Ogbo* ROSCA and ASCRA features. Apparently the hybrid societies also have a long history!

3. Titles entailed certain privileges comparable to modern social insurance and an old-age pension. “It is a Pan Igbo passport that guarantees him all prerequisites and accords him a place of honor and dignity among “foreign” associations” (Uchendu 1965: 82). Titles had to be paid for, the proceeds going to those who were members already and who could increase the entry price at their whim, at the cost of new, mainly young members. Of course, this caused much resentment.

Uchendu also argues that the old *Ogbo* system places too much power in the hands of a few headmen, abusing their privilege. A new system has since been developed to deal with this abuse (Uchendu 1966: 79), but the author unfortunately gives no further details.

Levin counts 16 ASCRAs in his village in 1981, of which 12 save for festivals and four for tax payment; meanwhile they grant loans to members (Levin 1981: 6). There are also five ROSCAs – local name *Akpe* – one having been set up in 1952 to allow each member to own a bicycle (Levin 1981: 6). The name bicycle club is also used by Nwabughuogu (1984: 51).

Levin does not mention village improvement societies, but reports that two church groups make "considerable contributions to village-wide projects" (Levin 1981: 15). So do the nine age sets in the village, whether through the village council or acting on their own initiative, particularly the seven younger age sets, that are well organized, and have members in school or working in towns (Levin 1981: 17). These clubs, with contributing members working in towns, resemble other improvement unions in Nigeria, Senegal and Cameroon.

Aforka's research in Anambra State dates from 1987. His village random sample covered 41 savings and loan associations: age sets, dance and masquerade groups. Initially, contributions were not used for making loans, but to finance communal projects, buy uniforms or launch a masquerade (Aforka 1990: 7). But the changing needs of members made the clubs start to provide loans to members in distress as a form of social security.

These clubs are typically all of the ASCRA type, with an average membership of 135, which is much too large for a ROSCA to function satisfactorily. Of interest is that Aforka emphasizes that only a small percentage of available funds is deposited at a bank. It is felt that "members' needs for the funds outweighs any benefit from banking the funds" (Aforka 1990: 8). The average annual interest on loans is 21.5 percent. This high loan rate is seen as a way of taxing themselves to build up their funds, which are redistributed after two years on average. This contention is supported by the practice in some associations, where members are forced to borrow when funds are in excess of loan demands, or have to pay interest whether they actually borrow or not (Aforka 1990: 10).[4]

Early Records of ROSCA and ASCRA Among the Ibo

One of the earliest eyewitness accounts of introducing ROSCA in an Ibo community in Southeast Nigeria comes from Green, an anthropologist who lived in the village Umueke Agbaja (between Onitsha and Port Harcourt) between 1934 and 1937. She uses the local name *Mikiri*:

> A voluntary group either of men or women or both, sometimes from one village, sometimes from more than one, who subscribe to a common fund for the benefit of all members. The whole collection would go to the member whose turn it was to benefit on that particular day and each member would benefit in rotation (Green 1964: 44).

Apparently, there had also been some prior attempts to start ASCRAs, but "this type had been abandoned because of the difficulty of avoiding embezzlement of the fund". Here, then, we have the opposite of Afikpo, where in Ottenberg's account the introduction of ASCRA preceded that of ROSCA. Green herself notes that "there are countless variations of customs from district to district and even within a small area" (Green 1964: 5). Ottenberg refers to an evolutionary process in line with Geertz's theory of "middle rungs in development", and he attributes the absence of ROSCAs in Afikpo to its economic backwardness. This seems unconvincing when one compares the "backward economy" of Afikpo in the late 1950s with the almost sub-subsistence economy of Umueke in 1937. Apparently evolutionary processes differ with the environment and do not follow a fixed pattern.

Village Elders as Moneyguards and Founding Fathers of the ROSCA

Of the authors on financial voluntary associations among the Ibo in Nigeria, Nwabughuogu (1984) provides the most authoritative account of the origin and evolution of *Isusu* (equal to *Esusu*). His paper is of particular interest because it sheds some light on other than financial issues, such as the normative behavior of the custo-

4. Such ingenuous financial practices in self-help groups may warn those in favor of linking indigenous savings and credit societies with formal institutions. It is important first to make a careful study of each society's financial performance before embarking a program of linkage.

dians of village funds; the extent of default in *Isusus* which in the old days appears (much) larger than is reported nowadays; and the power of the traditional village elders and others of rank, having command over resources such as land and labor (provided by the women) and, through the secret societies and title clubs, over the rituals that accompany the supernatural.

Consulting old colonial and court records as well as oral sources, Nwabughuogu finds that the *Isusu* developed “long before the establishment of colonial rule” and used by young men to pay the bridewealth needed for marriage. Initially, this only involved the depositing of savings with “trusted elders” of the village (Nwabughuogu 1984: 47). Gradually, these elders began to form themselves into little companies of custodians of young men’s money, after which the companies became a club that embraced the whole village (Nwabughuogu 1984: 47). The *Isusu* as a ROSCA was born, participants meeting usually each Ibo week of eight days, and contributing to a common fund that then rotated among them. This permitted the youngsters to have early access to bridewealth and funds for other purposes.

> Throughout the pre-colonial period the *Isusu* was the only means available to the poor classes of obtaining funds for the payment of dowry, purchase of titles and household goods, and paying expenses of burial and ritual ceremonies (Nwabughuogu 1984: 48, quoting a colonial memo of 1933).

The creation of the ROSCA resembles the inventiveness of those other custodians of other people’s savings, the goldsmiths of seventeenth century Europe, using gold deposits to create checking deposits.

Of Myths and Men

But how trustworthy were the “trusted village elders” really, who also played major roles in title clubs, secret societies and ritual ceremonies? The answer is important in the light of later developments reported by Ottenberg, in particular whether or not it was the apparent untrustworthy behavior of the *Isusu* leaders that prompted the urban and educated youth to start their own village improvement unions without the elders.

On this point Nwabughuogu is somewhat ambiguous. According to him, Warrant Chiefs allied themselves with unscrupulous moneylenders and traders who migrated from central Igboland to Ngwaland. Together, “they seized upon the *Isusu* as a speedy means of obtaining wealth” (Nwabughuogu 1984: 49) and started to manipulate the ROSCA in various ways.

I feel somewhat uneasy with this sudden appearance of the eternal scapegoats of the literature on the stage of the informal finance sector, as if the traditional club heads are only to blame by proxy for their misbehavior. Firstly, it is easy for an *Isusu* head to deceive the illiterate members. Bascom freely admits that “unscrupulous practices are so difficult to prevent that they are more or less taken for granted” (Bascom 1952: 68). Malpractices consist of a head taking two or more rounds for himself; letting members pay for the privilege of receiving the fund; or charging a fee for joining the *Isusu*. Bascom learned that among the Ibo and adjoining Ibibio “the settlement of *Esusu* accounts constitutes a high percentage of the cases tried in the courts” (Bascom 1952: 63). Uchendu admits that “the contribution clubs place too much power in the hands of a few headmen, abusing their privilege of nominating contributors for take-outs” (Uchendu 1966: 79).

Secondly, the malpractices of Nwabughuogu’s moneylenders appear less malpractice than sound banking strategy. They borrowed money from traders against 50 percent and put it in the *Isusu* to give loans at 100 percent. The loans attracted many people to join the *Isusu* (Nwabughuogu 1984: 49). In other words, they introduced a new element into the ROSCA, which now also provided loans from outside money.

Nwabughuogu may find the interest rates of these loans outrageous, but in a developing rural mini-economy, rates of 10 percent per month occur all around the globe. Nwabughuogu admits that:

> Despite this exploitation people patronized their *Isusu* clubs, that continued to serve as the main means through which the average Ngwa man could marry, begin trading, join the respected societies and meet other expenses requiring a large financial outlay (Nwabughuogu 1984: 49).

On closer scrutiny, some measures merely appear shrewd financial innovations, such as putting up future ROSCA shares as collateral for a loan, a practice now prevailing in many countries. That some heads demand 10 to 20 percent of a winner’s payout is also not unusual, as e.g. Aforka and Levin demonstrate. These deductions could start a separate fund for e.g. payment of taxes or schoolfees. Nwabughuogu himself notes that some heads attracted many people to their clubs by “paying schoolfees of children or giving loans to parents for the purpose” (Nwabughuogu 1984: 51). Finally, commissions charged by heads can be justified as compensation for the extra administration of new loans.

However, when one commission comes on top of another, one may suspect an overdose, meant to enrich club heads, as Nwabughuogu reports. There was also manipulation with the order of rotation, heads promising the same turn to two or more members and extracting money from all. The extent of mischief becomes really ingenious:

> There was also the tactic of recruiting into the club the most illiterate and unintelligent members of the community. Their names were not entered in the club register. At the end of the club, the monies paid by such people were expropriated by the club heads. Some of this category of contributors continued to make weekly contributions weeks after the proper life of the club was over (Nwabughuogu 1984: 50-51).

The "bicycle clubs" became another method of milking members, many heads charging double prices plus a commission. This and other wheeling and dealing had made the headship of an *Isusu* club synonymous with wealth and influence in Ngwaland by the late 1930s:

> They owned the best and largest parcels of land in their communities; they owned the best houses, married the most wives and were the first to purchase motor cycles and cars. They dominated the title societies. And by the 1940s almost all customary court judges were heads of *Isusu* clubs (Nwabughuogu 1984: 52).

But despite the extent of exploitation, the average Ngwa man did not want the colonial government to abolish the institution in favor of the cooperative thrift and credit societies. "All the petitions from the various communities against the *Isusu* asked not for its abolition but for a reform of the method of their operation, in order to minimize the exploitation by the club heads" (Nwabughuogu 1984: 54). Moreover, in 1951, which marks the end of Nwabughuogu's research period, "the rapacious exactions of the club heads had evaporated" (Nwabughuogu 1984: 54).

Improvement Unions, an Expression of Youthful Rebellion?

Regrettably, Nwabughuogu's account does not go beyond 1950 and gives no explanation for this reversal of behavior of *Isusu* heads. But the studies of Little, Ezeabasili and Ottenberg do cover the early 1950s. Putting their and others' observations into context, it is tempting to assume that the spread of education and urbanization and the subsequent appearance of the "improvement unions" are major causes of the changes in the *Isusu* and its leadership. These unions are founded by educated youngsters with some experience of urban values and lifestyles: Ottenberg's "politically progressive youngsters" who "limited membership of these unions to non-elders, in order to reserve control" (Ottenberg 1968: 242). Mission schools already existed in Green's remote village in the 1930s, while she comments on the "relatively wealthy and Europeanized urban centres Onitsha and Aba" (Green 1964: xiv). Little writes specifically about the urban environment.

Education makes people literate and more apt to spot manipulation of figures and accounts. As for urbanization, "Many (of the founders of the unions) had lived and worked away from Afikpo for a time, where they had been exposed to more Western political and economic forms" (Ottenberg 1968: 242). Both education and urbanization liberate them from the oppressive influence of the village elders and their almost total command over resources, economic, social, political and spiritual. Not surprisingly, one of the first tasks of the unions is to organize savings and credit mechanisms and limit membership to non-elders. All too long already the youngsters must have watched and endured helplessly the financial machinations of the *Isusu* heads.

Significantly, the unions and many other voluntary associations originate in the cities, away from the influence of the elders, although they are moulded after the traditional mutual aid in the home villages. "Under urban conditions people do not become detribalized, but tribalism itself becomes transformed" notes Jellicoe (1968: 27). In the cities the migrants establish their own institutions, usually on an ethnic basis, to help newcomers adjust to the realities of an urban lifestyle. The foremost pre-occupation of these associations is with social security and financial intermediation.

In Nigeria, the new unions and savings and loan clubs are soon off to a promising start. Thrift is endemic among the Ibo: "An adolescent boy who shows some signs of being wasteful is forced to join an *Ogbo* (=*Isusu*), where he is compelled to save" (Uchendu 1966: 80). Also, the high interest rates make the loan funds grow fast. It is unlikely that savings and credit behavior elsewhere in Africa is much different.

One can imagine that interference of elders in these new associations is not appreciated, given their earlier record of mismanagement. Likewise one may assume that the elders are loath to relinquish their traditional power and role of moral watchdog over the younger generation. How else to explain the letters to village parents, complaining that their daughters "bring public shame on the whole community" (Jellicoe: 38)? From Senegal have come stories that village women organized what comes close to a raid on a nearby town, to forcibly "repatriate" their daughters, accused of shameful behavior.

There is little explicit documentation of a youthful revolt against the (misuse of the) self-imposed prerogatives of village elders. It is my subjective interpretation that a confrontation between old and young, tradition and modernity, and a clash of value systems as illustrated in the preference for productive investments over those in traditional title and secret societies, is visible in the evolution of the *Isusu* and the efforts of the younger people to gain control over savings and loan associations.

Dupuy comes to a similar conclusion in her description of the "village associations" in urban Senegal. These associations, also run by young migrants, collect contributions not only for the benefit of the migrant community itself, but also for investments in their village of origin. Once a year the migrants return home with these contributions. The proverb "Who has the money, has the power" applies.

> Policymaking which used to be monopolized by a sort of council of wise men and based on discussion, is today having to accommodate the demands of those formerly excluded from such councils, mainly the younger people, who are now disputing this type of leadership. For some 10 years now, and in parallel with a renewal of the association concept, a sort of "democratization" of village political life has taken place (Dupuy 1991: 8).

Thus, in Dupuy's view, the young have brought democracy to the village. I am inclined to add: "And with a vengeance, too".

Final Remarks

Research on the evolution of financial self-help groups in Africa can prove a rewarding undertaking, provided it goes beyond the usual analysis of statistics, institutional organization, and financial technology. It is one thing to conclude that the *Tontine* and the *Esusu* increasingly combine rotating and accumulating funds to offer better deposit and loan facilities. Quite another conclusion is that the evolution of a financial self-help association does not take place in a vacuum; it reflects changes in a broader context. A close study of the motives and behavior of members that induced the organizational and financial mutations in *Tontine* and *Esusu* reveals the gradual changes that took place in the tribal and political arenas, and in the economic, cultural and normative systems of the society at large.

A major benchmark is the rapid evolution of urban self-help associations in the wake of the enormous influx of rural migrants. These migrants duplicated traditional village structures in the city in a quest for some form of security and stability in an unfamiliar environment. At the same time, the migrants achieved a measure of independence. While policymaking in the village traditionally is the prerogative of the elders, organization and leadership of the urban association is in the hands of the young, who were formerly excluded from power. In the cities, the young decide on the purpose of the association and the means to achieve it. The rules of the game are in writing, records and accounts are audited and replace the uncontrollable practices of the "trusted elders", suspected of manipulation and malversation. Formalization is effected through a proliferation of office bearers who even police monthly meetings to ensure proper conduct of members. Membership may even become multi-ethnic and sexually integrated, drawn from the office and workplace rather than the family or village circle. The urban "revolt" of the young simultaneously has brought some form of democracy to the village.

Given the general failure of many African governments to get real development off the ground, the accomplishments of the self-styled voluntary associations in Cameroon, Senegal and Nigeria in the domains of financial intermediation, social insurance, infrastructure and community development, assume truly gigantic proportions that more than rival the accomplishment of the European Cooperative movement. In the past, the efforts of colonial administrators to transplant this European cooperative model into African soil have met with little success. After independence, latterday development agencies are still trying, convinced as they are of the superiority of this model to make self help and democracy work. The above account shows that their concern is misplaced: the indigenous self-help model works, and with good results.

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