

INFORMAL AND FORMAL SECTOR FINANCE IN INDONESIA: THE FINANCIAL EVOLUTION OF SMALL BUSINESSES

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1. Introduction

This paper discusses a study of the financing of small businesses in the city of Yogyakarta, Indonesia¹. Since these small firms were heavily dependent on informal or non-institutional sources of funds, the study was also to a large extent one of informal finance. It was particularly intended to shed some empirical light on the widely held, but largely unsubstantiated, view that conditions in the finance markets in less-developed countries (LDCs) are such as to hinder small firms' access to external funds, and hence seriously constrain their growth.

An argument often made in the literature is that such finance as is available from formal lending institutions (most importantly, banks) is mainly directed to borrowers with an established reputation and collateral to offer. Although there is much truth in this argument, it does not necessarily follow that orthodox lending practices of banks and other institutions in respect of small firms are socially non-optimal. A major task of the present is to present arguments in support of the contrary view.

A second popularly accepted notion is that small firms are forced to rely on either very limited self-finance or exorbitantly expensive moneylender loans. An important finding of the study is that firms' financing options steadily widen over time as they build up their assets and their reputation. In other words, their cost of finance tends to fall as they age. Firms' restricted access to finance in the early phase of their "financial evolution" is clearly much less cause for concern — if at all — when viewed in this light.

The small-business sector relies on both formal and informal finance. The former aspect can be studied to some extent by looking at the formal lending institutions involved, and to this end the writer interviewed the managers of all the banks operating in Yogyakarta, together with a number of merchant banks and development finance institutions based in the national capital, Jakarta. This approach is not appropriate to the study of informal finance, however, since there is no clearly identifiable set of institutions or individuals which constitutes an "informal finance sector". Instead, it is necessary to look directly at the firms and individuals involved in informal financial transactions. To do this, interviews were carried out with the owners (or, in a few cases, high level managers) of some 120 businesses over a period of about ten months. Details of the information sought

¹ R.H. McLeod, *Finance and Entrepreneurship in the Small-Business Sector in Indonesia*, Ph.D. dissertation, Australian National University, 1980.

are given below.

No attempt was made to define "small" businesses. This is usually done by specifying an upper limit on the value of output, size of the labour force, value of net assets or some such. It was not considered necessary to formulate any such definition for the purposes of this study, because even a firm which may have been relatively large at the time was likely to have been small when it first commenced operations. Since the study is much concerned with the process by which small enterprises become large, nothing was lost by including at least some large firms in the sample.

In fact there are very few large firms in Yogyakarta, which is a relatively small city by Indonesian standards. The largest firm studied had a workforce of about 800 people and a small number employed a few hundred workers, but the majority fell within the ranges 5-19 and 20-99, which correspond to the Government's "small" and "medium" categories of firm size.

There are of course vast numbers of very small "businesses" in Indonesia whose workforces consist solely of the owners themselves or perhaps include a few members of their immediate families. The activities involved include hawking, the operation of *becaks*² and horse-drawn carts, market vending, and even raking over piles of garbage in search of recyclable materials. The study was not concerned with these sorts of activities, since they seem to be more in the nature of trades rather than businesses — in the sense that there is usually little or no attempt made to expand, diversify, accumulate capital or employ outside workers; their owners are best thought of as self-employed labour.

2. Bank Lending in Practice

To any person or organisation contemplating making a loan to another, the possibility of default is of fundamental importance. This risk distinguishes lending transactions from other kinds, and is central to explaining much of what we observe in finance markets.

Lenders come to terms with uncertainty in two basic ways. First, it can be reduced — by requiring the borrower to provide security for the loan, by acquiring information which

2 Tricycles with seating for two passengers.

will allow estimates of the probability of default to be made more confidently, and by monitoring the subsequent activities of the borrower. Second, it can be offset, by incorporating an allowance for default risk (anticipated loan write-offs) within the nominal lending rate offered to the intending borrower³.

These approaches are not mutually exclusive. All of the uncertainty-reducing measures involve costs, and for this reason there can be trade-offs between them. There is also a trade-off between these measures as a whole and the uncertainty-offsetting measure. Furthermore, it should be noted that the costs of uncertainty-measures and other administrative costs vary across different lender/borrower combinations. Other things being equal, the lender whose costs are lowest for a given borrower has a competitive advantage over other potential lenders. In particular, banks are not always the lowest-cost lenders, as shall be seen below.

(i) *Uncertainty-reducing measures*

(a) Provision of security

In regard to the relationship between asset endowments and borrowing opportunities, there is no doubt that lenders will be more willing to lend (or to lend at cheaper rates), if the borrower has suitable assets with which to secure the loan. The reason is straightforward: the more adequate the security provided, the more certain the lender can be that the loan will be fully repaid. But the impression given by many writers is that there is something inefficient or undesirable about lenders requiring security. It seems all too easily forgotten that all investment projects are risky, and there is no reason why the lender should bear the risk — except if he is compensated to the extent he considers adequate.

The reader can readily imagine the strength of demand for, say, million-dollar loans if they could be had at moderate interest rates and without the provision of security. The idea of playing with someone else's money is an appealing one: if the borrower's gambles — or investment projects — are successful he gains, but if they fail, someone

³ The nominal lending rate exceeds the expected rate of return on a loan because of the possibility of default. If the required expected rate of return is r per cent, and the probability of outright default on principal plus interest is estimated to be p , then the nominal lending rate must be set at

$$n = (100 + r)/(1-p) - 100.$$

else loses. By requiring security to be provided, the lender encourages the borrower in the most direct way to carefully judge the likely success of his proposed investment. This is highly desirable, for the borrower can usually gather and analyse information regarding an investment within his own field of specialisation at lower cost than can the lender. Nor should it be forgotten that (from the lender's point of view) there is a risk involved other than that attached to the investment project itself—namely, that of wilful default on the part of the borrower. Security greatly strengthens the lender's position in this regard.

Contrary to the popular views outlined above, bank insistence on the provision of collateral seems consistent with efficient allocation of investible resources. There is most likely a high degree of correlation between (sound) investment opportunities and endowment of assets (and thus, ability to provide collateral). A businessman who is well endowed with assets is likely to have become so by having had a high income in the past and, of course, by having chosen not to dissipate it all in correspondingly high consumption. Clearly, the accumulation of wealth is therefore one of the best indicators of entrepreneurial ability⁴. Conversely, one who has accumulated little wealth is likely to be an unsuccessful entrepreneur, a spendthrift, a gambler, or a business novice who may or may not turn out to be successful. It seems reasonable to assume that an entrepreneur who has been successful in the past will probably continue that success in the future.

There are good reasons, then, for requiring security for loans, whereas arguments against the practice seem almost non-existent. It is trivial to point out that some sound investment projects may not be undertaken for want of suitable collateral, because some unsound projects will also be precluded for exactly the same reason. On balance, the latter effect can be expected to dominate (if the foregoing arguments are valid), and it can hardly be argued that society is disadvantaged by a practice which systematically selects for implementation those investment projects with the better chance of success.

Two basic means of securing loans exist. The first requires that items used as security be placed in the physical possession of the lender, then to be sold in the case of default. This is the system used by pawnshops and, in the case of Indonesia, by village or market

4 Other possibilities are not discounted. Wealth may be inherited, acquired by virtue of good political connections, or even stolen. But this does not refute the argument that asset endowment and entrepreneurial ability are closely related: it is not suggested that the correlation is perfect.

banks (*bank desa/bank pasar*)⁵. This method can be highly effective in reducing the lender's uncertainty. The village and market banks appeared to have no significant problem in relation to bad debts, and it seems reasonable to assume that little or no allowance was built into their lending rates to offset default risk⁶. Although borrowers benefit in this way, however, a cost arises because the borrower has to forego the use of assets provided as security for the duration of the loan. The system is therefore of rather limited usefulness, especially in the context of lending to business enterprises (rather than private individuals).

The second method of effecting security for loans is designed to remove the abovementioned disadvantage. It relies on legal documentation which allows the lender to assume ownership of certain of the borrower's assets in the case of default; this was the system mainly used by the commercial banks in Yogyakarta. The preferred form of security was title to real estate, but vehicles, machinery and inventories were also used to some extent. While it leaves the borrower's assets in his possession, this system of security has its own disadvantages. In Indonesia at least, proper legal documentation is costly to prepare; more important, it is expensive to enforce. The process of liquidation is often protracted, and forced sales rarely seem to realise sufficient funds to cover the full amounts outstanding— despite the fact that the nominal value of security is usually considerably greater than that of the loan. For these reasons banks invariably hope not to have to resort to liquidating borrowers' assets, and they try hard to avoid doing so. Nevertheless, security of this kind does serve the important function (already mentioned) of threatening the borrower with a substantial penalty if he defaults.

Because of the impracticability of physical-possession type security for loans to businesses and the costliness of, and other difficulties with, the legal-documentation type, the commercial banks must give a good deal of attention to other uncertainty-reducing and -offsetting measures. In sharp contrast to the "no-questions-asked" approach of their village and market bank competitors, and despite the tendency in the literature to ascribe overriding importance to collateral, its availability was in fact no guarantee of obtaining a bank loan; rather, it was merely a prerequisite.

(b) Information acquisition

The most obvious ways of acquiring uncertainty-reducing information are by interview-

⁵ These banks do not provide cheque account facilities. Hence they are referred to as "secondary banks".

⁶ There must be an allowance for the cost of safe-keeping borrowers' assets, of course.

ing the borrower, inspecting his place of business, and requesting him to submit a variety of data. The latter typically comprise: lists of fixed assets, inventories, debtors, creditors, suppliers, customers, and agents; estimates of normal operating expenses and revenues; descriptions of contracts previously undertaken and currently in hand; financial projections or feasibility studies for new investment projects; and so on.

The extent of such information acquisition depends largely on the size of the intended loan: it is not worthwhile to attempt to obtain too much detail for small loans. Indeed, one of the biggest problems in lending to small firms is that their book-keeping is often poor or non-existent. The owners are usually capable of storing all of the relevant information (about prices, costs, revenues, money owed and owing, and so on) in their heads, and this makes it very difficult for an outsider such as a bank to judge the firm's financial condition and its ability to profitably employ additional funds.

In this circumstance, banks in Yogyakarta usually required the prospective borrower to maintain a cheque account for three to six months before they would consider making a loan. Cash flows into and out of the account could then be monitored to provide at least some of the information which would otherwise be recorded in the firm's books⁷. This, of course, is a very cheap way of obtaining additional knowledge of the borrower's activities.

Third parties with knowledge of the intending borrower's character and activities were the other major source of information used in loan proposal evaluations; these included the applicant's customers, suppliers, neighbours, other banks and so on. It is very important for branch managers to maintain a wide range of contacts within the business community to whom they can turn for such assistance.

(c) Monitoring

For some loans, banks supervise the expenditure of loan money (for example, by paying in direct to the supplier of items of plant and equipment, or checking with the supplier's bank to see that payment has been received) and monitor the activity of the firm, by visiting its place of business or by requiring regular financial or trading reports to be submitted. Again, these procedures are often too costly in relation to small loans to be worthwhile. Nevertheless there is always at least some monitoring, even if it amounts

7 For many small firms, bank statements are a helpful first step towards keeping systematic records of their operations.

to nothing more than checking to see that scheduled loan repayments and interest commitments are being met.

The rationale for monitoring is that it gives the bank early warning of potential defaults. In turn, this enables it to embark upon such course of action as seems appropriate. This may amount to little more than a telephone call or visit to the borrower to ascertain the nature of the problem, followed by minor re-scheduling of repayments. On the other hand, if there is evidence of insoluble business difficulty or deliberate intent to defraud the bank, the necessary legal procedures can quickly be put in train.

(ii) Offsetting uncertainty and administrative costs

In a freely functioning banking system, banks can be expected to seek an optimal (profit-maximising) combination of effort devoted to reducing uncertainty, on the one hand, and interest rates sufficient to cover both default losses and administrative costs, on the other. Since bank loan transactions can differ substantially amongst themselves—in particular, with respect to the credit reputation of the borrower, the quality of collateral offered, and the size of the loan—it can be expected that this optimal combination will likewise differ across different transactions.

At one of the banks in Yogyakarta, for example, lending rates ranged from 19 to 27 per cent p.a. The exact rate chosen reflected the nature and value of assets offered as security and the bank's evaluation of the borrower's character and ability, as well as the size of the loan. In regard to the latter, the minimum rate for loans of up to Rp50 million was 24 per cent; rates for loans greater than this were more readily negotiable. Furthermore, interest rates tended to be lower for borrowers with long-established businesses and for those who had maintained a sound borrowing relationship for some time.

3. Banks and Competing Sources of Finance

The extent to which banks can offset anticipated loan losses and administrative costs by raising their lending rates is constrained by the demand conditions under which they operate. Demand curves for bank loans are by no means perfectly inelastic. Potential borrowers faced with higher bank lending rates have several other options available

to them, which are discussed in detail below. For example, they can reduce expenditure by hiring rather than purchasing expensive items and by purchasing second-hand rather than new plant and equipment. They can switch to other sources of funds. And, of course, they can simply postpone or shelve planned consumption or investment spending.

These considerations afford a plausible explanation for various characteristics of bank lending. For example, each bank had some lower limit on loan size. One bank manager argued that there was "no demand" for loans smaller than the lower limit. The proper interpretation of this—as suggested above—appears to be that there would be no demand for smaller loans if the interest rate attaching to them were set sufficiently high to offset the default probability and cover administrative costs (which of course tend to be very high in per unit terms for small loans). As another manager put it, his bank could not compete with other lenders such as the village and market bank in the provision of small loans.

At the other extreme, the larger the loan, the more resources can profitably be devoted to loan appraisal. Not only is more information collected and analysed at the branch level, but also higher levels of bank management become involved in the decision-making process when loans exceed specified limits. Although this increases the bank's costs in absolute terms, the lending rate can still be lower than that for smaller loans because costs per rupiah loaned are less. Nevertheless, the commercial banks begin to run up against competition from other sources as loan size increases—namely, from development banks, merchant banks and other non-bank institutions—which specialise in large-scale financing activities.

It seems more meaningful to explain these aspects of lending activities in LDCs in terms of the basic notion of specialisation or "division of labour", rather than merely asserting that financial institutions "have borrowed the practices and traditions of those in metropolitan centres abroad"⁸. Likewise, to say that, "small firms... often lack access to institutional credit"⁹ is quite misleading. It is more to the point to argue that institutional lenders to some extent "lack access to"—or cannot compete in the financing of—small firms.

8 Rattan J. Bhatia and Deena R. Khathkate, "Financial Intermediation, Savings Mobilization, and Entrepreneurial Development: The African Experience", IMF Staff Papers 22 (1) 1975, p. 136.

9 World Bank, *Employment and Development of Small Enterprises* (Washington, 1978) p. 6

4. Banks and Small Business

It is broadly true that banks are not concerned with financing beginners in business. They do not lend to persons who have yet to accumulate some minimum amount of assets, or to demonstrate both capability in business and creditworthiness; nor do they provide loans below certain minimum amounts.

Nevertheless it would be wrong to infer from this that banks are not interested in small business. A customer who can profitably use a Rp100 million credit line is certainly a much more interesting proposition than one who can only use Rp10 million, but the fact is that there are relatively few large businesses in LDCs such as Indonesia. Consequently the banks have little choice but to rely on small firms for a large part of their income. Perhaps more important is the fact that many small firms soon grow to become large ones; the bank which fails to win the custom of firms when they are small may find difficulty in doing so when they grow larger.

One of the important tasks of bank branches, therefore, is to seek out and gain the accounts of small firms with good future prospects. Once a firm has attracted a bank's attention, it is usually only necessary for it to operate a cheque account for a short period before it can begin borrowing. In contrast to the significant difficulties involved in obtaining a bank loan for the first time, subsequent loan renewals are largely a formality (provided of course that the borrower meets his commitments); furthermore, it is usual for the loan size to be increased and the interest rate to be reduced over time. It is clear then that the supposed lack of access of small firms to bank finance is greatly exaggerated. Indeed, it is worth noting that it was by no means unusual for offers of bank loans to interviewed firms to be rejected, and that quite substantial numbers of small firms did not even operate any kind of bank account.

5. Diversity of Financing Options

A partial explanation for the fact that many small firms have no banking relationship is that there are various means by which entrepreneurs can deal with the finance problems they face, of which bank borrowing is only one. To gain an appreciation of the other options, as already mentioned, the writer interviewed a large number of small firms, in a wide range of industries. The main information sought in these interviews was as follow:

(i) *Background*

What was the nature and level of the owner's education, and what was his previous working experience? What were his parents' vocations and those of his other close relatives?

(ii) *History of the firm*

When was the firm established, and by whom? What initial investments were undertaken? What expansion and diversification have occurred subsequently? What was the legal form of the enterprise?

(iii) *Current activities*

Who were the suppliers to, and customers of, the firm? On what terms were purchases and sales made? What was the size of the labour force? What payment system was used? Were sub-contractors used? Were items of capital leased or rented?

(iv) *Banking relationship*

Did the firm have a cheque account? Had it made use of bank loans, and if so, on what terms? How was the quality of service provided by banks rated?

(v) *Other finance arrangements*

Did the firm use non-bank sources of finance, and if so, on what terms? Did the firm provide loans to other firms or individuals?

It can be seen immediately that the data collected for any one firm do not relate merely to its condition at a point in time. Rather, they represent a case history—in most instances stretching over several years, but in others for more than a generation, since several firms had been handed down by their founders to their children and even their grand-children. The information collected in the interviews has been presented as a series

of some 116 case studies¹⁰. One such is presented later for illustrative purposes. A description of the various financial options described in these cases is provided in the following sections.

(i) *Self-finance*

To begin, it must be emphasised that many firms relied heavily on self-finance for their expansion, and that often they did so by choice—not because they were denied outside finance. Nor was reliance on self-finance a bar to rapid growth of businesses. The more capable entrepreneurs operated their enterprises so effectively that the re-investment of profits was more than adequate to ensure very rapid growth. Of course, a firm which generates little profit cannot be expected to grow rapidly by self-financing its investments, nor will it be easy for it to borrow. But it can hardly be argued that this reflects any inefficiency in the capital market. The reverse is true, since a well functioning market will direct funds to those best able to manage them—in other words, those able to achieve relatively high returns.

Although self-finance usually implied the re-investment of profit, it sometimes also meant the sale of assets of the firms (for example, if it was decided not to persevere with a particular activity) or those of its owner (for example, land or jewellery). Self-finance of course always requires that the firm's owner be prepared to forego some present consumption in the expectation that the opportunities for future consumption will be expanded by virtue of the investment being undertaken. Many businesses grow slowly, if at all, simply because their owners are not prepared to make the sacrifices (in terms of current consumption and leisure) which are necessary for rapid growth.

Another aspect of self-finance was the provision of funds by individuals who became shareholders or partners in the firm concerned. Although there are very many small, limited liability companies and limited liabilities partnerships in Indonesia, it should be noted that the number of shareholders or partners in each case is almost invariably small; they are usually relatives or friends of the principal owner-manager. There is almost no trading in such firms' shares nor public issues of debt or equity; often such businesses are legally incorporated simply to enable them to obtain some kind of licence or government concession. Nevertheless, some firms did increase their capital base significant-

¹⁰ McLeod, *op cit*, Appendix A.

ly in this manner.

One other very common informal equity-financing method for small businesses was observed. The procedure was for an outsider (often a middleman) to finance working capital requirements in return for a certain share of revenue of the enterprise (rather than for a predetermined repayment). The outsider was therefore effectively a shareholder in the business, but took no management role in it. The important difference between this system and that discussed above is that equity is held for a defined period rather than indefinitely. The most obvious example is agriculture (although agricultural activities were excluded from the present study); here the "equity period" is the time between planting and harvest. Another example was the "hiring" of "Colts" (small motor vehicles used for carrying passengers or goods); in this case the period was as short as a day.

(ii) Reducing the size of the financing requirement

There are various ways in which entrepreneurs can reduce the size of the total capital outlay needed in order to set up or expand their enterprise.

(a) Hire or rental of capital items

Although the task of the entrepreneur is to bring together the factors of production, it is not necessary for him to own them. Labour, of course, is not owned but hired, and there is no reason why items which would otherwise involve a substantial capital outlay cannot similarly be hired or rented. In this sense, the rental market for physical capital items can be thought of as a part of the finance market. Instead of one party making a monetary loan to another (directly or via an intermediary), the former purchases the required item of physical capital and lends it to the latter. The most obvious examples were land and buildings, but the practice was not uncommon in respect of other kinds of physical capital, such as motor vehicles and construction equipment.

(b) Sub-contracting or putting out

Not only is it unnecessary for the entrepreneur to own the factors of production; in some cases it is feasible for the entire production process, or parts of it, to be sub-contracted (or put out) to other firms or households. The entrepreneur does not then need to find finance for equipment or a work place for the process. By delaying payments to his sub-contractors he can also reduce his need for working capital.

(c) Purchase of second-hand items

The size of the financing requirement for entry into a particular field of business (or for subsequent expansion) can often be greatly reduced by purchasing second-hand, rather than new, items of capital. Opportunities for this arise when other firms upgrade their own equipment or quit the field. A capable entrepreneur can often make a good start in business in this manner. Even if second-hand equipment of the right kind is not readily available, a start can be made using improvised equipment.

(iii) *Sources of external finance*

The various sources of external funds to which firms may have access can now be considered.

(a) Supplier credit for capital items

The suppliers of capital items have some incentive to finance customers' purchases, in order to boost their own sales. Terms and conditions varied from case to case. The interest charge was sometimes explicit, and sometimes simply built into the purchase price and agreed payment schedule. Legal documentation of the agreement was sometimes but not always required, and the time for repayment was often flexible. As a rough guide to typical kinds of agreement, items as diverse as buses, trucks and restaurant equipment could be purchased on 25 to 30 per cent deposit at 18 to 24 per cent p.a. interest (somewhat less than the cost of loans from the private banks), with repayments extending over one year to eighteen months.

(b) Trade credit

Financial requirements relate to working capital as well as to fixed assets. Much of the working capital requirement can be financed by trade credit, including both credit from suppliers of inputs and advance payments from customers. The extent to which this occurs appears to depend largely on industry characteristics: advance payment by the customer is much less likely for a bus line than for a construction company, for example. Note also that in some cases the entrepreneur will find it more to his advantage to finance his suppliers or customers than conversely. That, of course, is simply the

opposite side of the same coin.

Again, credit terms varied from case to case. Credit was extended for as little as a day or two and as long as two to three months. Discounts offered for cash payment were as little as 1 or 2 per cent and as high as 10 per cent, depending on the industry concerned, but a charge of 3 to 5 per cent per month for trade credit could be regarded as typical. Often it was taken for granted that credit would be accepted, and no cash discounts were offered.

(Trade credit is utilised in developed and less-developed countries, in rural and urban areas, and for both small firms and large. Its ubiquity is powerful evidence in favour of the argument that banks are not always the lowest-cost source of finance. Clearly, bank overdrafts and trade credit are very close substitutes; widespread reliance on the latter suggests that it is a more efficient financing arrangement—cheaper, when all the relevant factors are taken into account—in certain circumstances).

(c) Family, friends, fellow business owners and friends-of-friends

Business owners typically borrowed and lent amongst their circle of family members, friends and fellow businessmen. Such transactions sometimes carried an explicit interest charge, but sometimes there was nothing more than an implied obligation to provide similar assistance to the same, or another, member of the group on some future occasion. Lending was also transacted between friends-of-friends. A typical case might be that Mr Sudarno might not have any surplus funds to lend to his friend, Mr Suparno, but he might be able to provide Mr Sukarno. Typically, lending rates in this informal short-term money market were of the order of 3 to 5 per cent per months, and most loans would be repaid within a month or two—often considerably less.

(d) Banks, moneylenders and other financial institutions

Certain firms and individuals specialise in the business of providing finance to others. In some cases this involves lending only their own funds, but they may also act as intermediaries for other lenders. The cost of bank loans has already been discussed. Financial institutions dealing in very large loans to highly respected customers were able to lend at somewhat lower rates. Moneylenders' rates in Yogyakarta were often of the order of 5 per cent per month, within the range 3 to 10 per cent.

One interesting case was that of the several moneylenders operating in Yogyakarta's main market. It was estimated that about one-third of all the traders there borrowed

from moneylenders to finance their stocks. Typically, their debt was of the order of Rp10,000 to Rp50,000, and the interest rate was about 7.5 per cent per month. Interest was calculated daily and paid to the moneylender as he made the rounds of his clients. Alternatively, the trader might decide to borrow an additional amount or to reduce the balance outstanding.

The reader may feel inclined to the view that this is a "usurious" rate of interest, but the following rough estimate of the moneylenders' costs suggests otherwise. Suppose our "travelling banker" employs someone on a modest salary of Rp250,000 per month or Rp10,000 per day, or to notionally pay himself this amount. Assume he services 80 customers per day (equivalent to about 10 per hour, or about 6 minutes per customer). Finally, assume the average loan outstanding is Rp50,000. Then the cost per customer per day is Rp125. Expressed as a percentage of the loan balance this is 0.25 per cent per day, or nearly 8 per cent per month—roughly equal to the level reported here, before making any allowance for the moneylender's own cost of funds. Evidently, the moneylender's customers are happy to pay this rate; the value of the service provided—obviating the need for costly trips to a bank to deposit or withdraw cash—would appear to outweigh its cost.

6. Case Study: Yogyakarta Bus Company¹¹

Interviewee: Mr Sutarjo, age 45

Sutarjo's parents were farmers. He had some elementary school education, but this was interrupted by the Japanese invasion and the subsequent struggle for independence against the Dutch. In his teens he had an interest in driving and appears to have had some lessons in Yogyakarta. Later, he went to Surabaya and got a job as driver's assistant, which he held for about four months. During this time he gained experience both in driving and in the repair and maintenance of motor vehicles.

At the age of twenty-two he married, and at about this time his parents managed to buy him a second-hand truck, enabling him to establish his own cottage business. He drove it himself as well as carrying out any necessary repairs. After about five years he had saved enough to be able to purchase a second truck, which had to be restored

¹¹ Pseudonyms are used to preserve confidentiality. Where the present tense is used, it reflects the situation as it was at the time of the interview.

to working order before it could be used. Two years later this was repeated when another truck owner was forced to sell his vehicle due to his inability to carry out necessary repairs.

After a further five years he decided to change the emphasis of his business and began trading in timber. Apparently he was able to earn a living from this activity, but it was not very profitable and so he sold one of the three or four trucks he owned by this time and bought a second-hand bus from a person who traded in used vehicles. He drove this himself on the route between Yogyakarta and a small town nearby. Meanwhile he continued to employ other workers to operate the remaining trucks.

Within two years, he was sold another second-hand bus by a trader, this time on credit. There was no formal agreement or contract concerning repayment terms; it took about one year for him to be able to complete the repayments. Soon after this purchase, he employed carpenters to convert one of his trucks into another bus, using timber rather than metal for the bodywork and seating. A year later he purchased the shell of a fourth bus and combined it with the mechanical components of another of the trucks.

During the last five years the number of buses has increased to thirteen. Apart from the first four, they have been purchased new. The first two new buses were fully financed by a loan of Rp7.5 million from one of the banks. The loan extended over two and a half years and was repaid on time. Subsequently, Sutarjo has had no further bank loans, and indeed now has no relationship at all with any bank. He has purchased an additional seven new buses (one at a time) from the Ford and Mercedes-Benz dealers in Yogyakarta. Both these firms have provided finance on fairly similar terms: 20 to 30 per cent down payment, with 12 to 18 months to repay at about 1.8 per cent per month interest. Sutarjo prefers the simplicity of supplier finance to the difficult and time-consuming process of obtaining bank loans—even though the latter are nominally cheaper. He intends to expand his fleet, but does not wish to be too much in debt. New purchases will therefore be undertaken only to the extent that profitability of the enterprise permits existing credit to be repaid.

The business has about forty employees, consisting mainly of three-man teams for each bus in the fleet. Sutarjo no longer drives buses himself, but undertakes mechanical work and the general management of the business; his wife also assists in the latter. They have no other business interests other than owning a small amount of rice growing land, which is worked by employed labour.

Their home is situated in a rural area about fifteen kilometres from the centre of Yogyakarta. It was handed down from his parents, but has been substantially renovated and ex-

tended. Although much bigger and of better construction than the homes of the farmers round about, it is still very simple: the furniture is quite basic and there is nothing suggestive of "conspicuous consumption". A covered workshop large enough to accommodate three buses has been constructed adjacent to the house.

7. The Process of Financial Evolution

Analyses which stress the supposed lack of access of small firms to external finance are essentially based on snapshots, whereas a much more meaningful perspective is afforded by moving pictures. Such analyses never question why it is that some firms are large and some small, by what process the currently large firms came to be that way, or whether there is any logic in suggesting that small, relatively unproven (or even unsuccessful!) business owners should be able to obtain external finance on the same terms as the owners of larger businesses who have already demonstrated their ability to use resources effectively.

Since small firms have poorer access to finance than large, and since many large firms (probably, the great majority) were small at the time of their establishment, it follows that access to finance must widen as firms grow—or more generally, as they age. Having discussed the diversity of means of financing the capital requirements of enterprises (both large and small), the next step is to elaborate upon this concept of "financial evolution" of firms—that is, the notion that the range of financing options tends to widen over time, resulting in a concomitant reduction in the cost of finance to the firm.

The case studies on which this paper is based typically show that, after a pre-establishment phase during which the prospective business owner obtained some kind of formal or informal preparatory training, he received relatively modest backing from his family (usually his parents), or perhaps from a close friend, to help finance the establishment of his enterprise¹². Following this he depended very largely on the re-investment of profits to finance the initial growth of the firm. As time passed the circle of people and firms willing to provide him with finance widened, and eventually came to include banks and perhaps other formal financial institutions.

It is not difficult to explain the process of financial evolution of the business owner. At

12 This often closely coincided with the time of marriage—which seemed to symbolise the moment at which the son or daughter became independent of the family.

the time when he takes his first step in business, he has no reputation in respect of either business ability or creditworthiness, in the business community. He is unlike, therefore, to enjoy financial backing from any party outside his immediate family and circle of close friends, because the outside financier has virtually no basis for ascertaining the chances of recouping his funds. Family and friends are much better placed in this respect; besides, they are usually motivated in such instances by a sense of obligation to the person, rather than by purely commercial considerations¹³. In many cases, of course, parents simply hand down control of an already established enterprise after the son or daughter in question has gained sufficient working experience to be able to manage it.

The next stage is a phase of consolidation and learning by doing. It is the period during which the business community evaluates the individual's talent for business—when it discovers whether he has what is necessary to succeed as an independent business owner. In this phase, he is very much restricted to self-finance: his family has fulfilled its obligation by helping him to get started, but the business community does not yet feel well enough informed to provide him with additional funds. Nevertheless, by virtue of the simple fact of a business being in existence, information is constantly generated within the business community about it and its owner. Two kinds of such information can be distinguished—that which concerns the ability of the owner to perceive opportunities for profit and to bring them to fruition, and that which concerns his record in such matters as honesty, reliability, eschewal of "sharp practices" and so on.

The people in the best position to acquire information of these kinds are those closest to the business owner—both in terms of physical proximity (neighbouring individuals and firms) and in terms of business matters (competitors, suppliers, customers, employees, bankers, and so on). Information is accumulated by these people and firms, and then filters out to the wider community. The main driving force is the value of knowledge, for one of the most important keys to success in business is to be well-informed. Nobody wants to find himself doing business with, owed money by, or in any other way dependent on, an unreliable firm or individual. The new business owner is therefore watched by many during the period in which he consolidates his position in the business world.

Suppliers of inputs will soon see whether the new firm is successful, by paying attention to growth (or lack of it) in the orders it places. If the indications are favourable, they

¹³ Financial assistance from parents for the establishment of a business is no different in principle from (and can be interpreted to include) similar assistance for the acquisition of human capital through education.

are likely to begin to extend credit on purchases. Likewise the supplier of capital goods is well placed to observe the firm's performance and thus to evaluate the risk which would be involved in financing its purchases of such items. The firm's customers will concern themselves with its reliability regarding product quality, adherence to agreed delivery dates and so on, all of which is relevant in building up a picture of the firm and its owner as being worthy or unworthy of the trust of the community. A firm which establishes a good reputation may then find that its customers are prepared to make advance payments on their orders. Besides trade credit, bank finance eventually becomes available: as we have seen above, one of the important functions of bank branch managers is to seek out and gain the custom of small firms with good future prospects. As well, it becomes possible to borrow from friends and associates.

To summarise: the longer a business continues to operate successfully, the wider the financing options open to its owner. The riskiness of lending to it declines, or is perceived to decline, within the business community of which it is a part, and the price paid to compensate for this risk declines correspondingly. The business owner becomes freer to search for the kind of finance which offers him the most attractive combination of characteristics. Nominal cost is only one of several aspects taken into consideration; he will also be interested in the swiftness with which finance can be arranged, the amount of information disclosure required, security arrangements, the repayment schedule, and so on.

The case study presented here clearly illustrates many of the ways of solving the finance problem and how different financing techniques tend to make their appearance according to the stage of financial evolution attained. The original investment, financed by Sutarjo's parents, followed a period in which he gained practical experience in the motor transport industry. The initial growth phase was characterised by profit re-investment, although sometimes one kind of asset was sold in order to purchase another. Early expansion involved the purchase of second-hand trucks and buses, thus keeping capital outlays small. Eventually Sutarjo's reputation was such that he could purchase a second-hand bus on credit from a trader. By the time he started buying new buses he was able to obtain bank finance. Later, hire-purchase credit from bus suppliers became available.

Note especially that Sutarjo eventually had the choice of bank funds or supplier credit, but came to prefer the non-institutional source of finance for additional investments—despite the fact that it was somewhat more expensive. Given the likelihood that the credit provided by the bus suppliers was itself obtained (at least in part) from institutional sources, we may surmise (as in the case of trade credit noted above) that it is

often more efficient for banks to act as "wholesalers" rather than "retailers" of funds. By this process, many firms gain indirect access to institutional finance.

It might be argued, however, that this case study provides evidence of market imperfection. Sutarjo is one of a fortunate minority of individuals whose parents happened to be sufficiently well off to be able to set him up in business. By implication, many other "Sutarjos" may never get the chance to demonstrate their entrepreneurial talents, simply because their parents are too poor to do the same. Furthermore, at least some more wealthy parents may put capital at the disposal of sons and daughters who would then use it inefficiently.

In other words, if there were some omniscient deity willing to reveal which persons had latent entrepreneurial ability, then capital could be directed to the control of this group; society would obviously benefit. In this sense, there is a "market imperfection". To judge the efficiency of markets with respect to this standard, however, does not seem helpful. "Complete information" is a useful assumption for constructing many economic models, as is the assumption of "zero transport costs". But the admission that information gathering and transportation are costly does not, in any meaningful sense, imply that markets are imperfect. The only relevant issues are whether there are available more efficient means of production of information or transport, and whether the optimum amounts are being produced.

It can therefore be conceded that some potentially able entrepreneurs will be constrained by lack of capital, and that others less able will put it to bad use. Until some better way of identifying latent entrepreneurial talent is found, however, there is no basis for arguing that this problem is indicative of market imperfection.

(There are those who advocate policies such as concessional credit for small or new enterprises, with reduced emphasis on "commercial" lending practices, as a means of ameliorating the finance difficulties these enterprises face¹⁴. Such advocacy appears to require acceptance as an article of faith that the benefits to society of discovering "good" entrepreneurs by this means, or doing so earlier, outweigh both the administrative costs and the costs of unintentionally placing capital under the control also of "poor" entrepreneurs¹⁵. Evidence capable of supporting this contention appears to

14 See, for example, D. Anderson, "Small Industry in Developing Countries: A Discussion of the Issues", *World Development* 10 (11) 1982, p. 933.

15 This unwanted side-effect is unavoidable—unless orthodox "commercial" lending practices are inferior to other means of allocating loans amongst borrowers.

be non-existent).

In any case, it should be re-emphasised that individuals do not need to have a relatively large amount of capital at their disposal before they can demonstrate their entrepreneurial ability. Consider Ms Tjan—now the owner of a thriving restaurant—who started out selling *sate* from a roadside stall¹⁶. Having demonstrated her entrepreneurial ability and built up some savings, she was eventually able to borrow from various relatives and friends in order to establish her first small restaurant. Consider Mr Suseno—now the owner of a huge metal casting and fabricating plant—who began his career producing peanut oil, employing just two workers to pound peanuts by hand and using a rice cooking pot to extract the oil¹⁷. Consider Mr Untung—now the owner of a large and rapidly expanding automotive dealership and workshop—whose first venture was the production of receipt books from scrap paper cut to size by hand¹⁸. These and various other case studies tell the same sort of story: where entrepreneurial talent exists, it will eventually find an outlet for expression.

Of course, it is inherently impossible to disprove that sometimes this does not happen. We have no convincing test of entrepreneurial ability other than evidence of success as an entrepreneur. If such evidence is lacking, the explanation could be lack of ability or lack of access to finance. (Further possibilities could also be suggested—such as a regulatory environment not conducive to the exercise of entrepreneurial flair¹⁹.) Those who favour the finance constraint explanation, however, must explain why many new entrepreneurs are able to surmount financing obstacles to their progress while others cannot.

The writer's interpretation of the case study material as a whole is that obtaining finance is just one item in a long list of problems encountered during the attempted exploitation of opportunities for profit. The list also includes understanding available technology, organising the use of factors of production in accordance with that technology, dealing with all government agencies with an interest in the enterprise, handling industrial relations and public relations, delegating responsibility to managers and supervisors, marketing the product, responding quickly to changing circumstances, and so on. With

¹⁶ McLeod, *op cit*, Case Study 77. *Sate* consists of small pieces of meat, barbecued on a bamboo skewer.

¹⁷ *ibid*, Case Study 32.

¹⁸ *ibid*, Case Study 64.

¹⁹ A discussion along these lines can be found in McLeod, *op cit*, Ch. 7.

the exception of having the awareness and imagination to perceive opportunities for profit in the first place, the ability to cope with all these kinds of problems would seem to be the most fundamental component of entrepreneurship. In short, it seems much more plausible to argue that lack of entrepreneurial ability makes access to finance difficult, rather than that lack of access to finance holds back entrepreneurship.

8. Conclusion

The notion that lack of finance is a major obstacle for small firms is not supported by the study described here. Indeed, the contention that entrepreneurs' plans for expansion are thwarted by lack of access to credit does not sit well with the observation that a very large proportion of economic activity (even setting aside primary sector output) is organised by small firms²⁰, nor with the fact that most of the successful and rapidly growing firms interviewed during the course of fieldwork had extremely modest beginnings. If finance is the problem that it is often made out to be, how is it that small firms are able to prosper and grow?

Furthermore, although it is true that finance is often considerably more expensive to small, new firms, and that their range of financing options is more limited, there is no compelling reason to believe that these observations reflect imperfections (that is, departures from social optimality) in LDC finance markets. Finance transactions involve uncertainty because of the time element involved. Efforts to reduce uncertainty are costly, and they are subject to economies of scale; uncertainty is greater when the borrower has yet to establish a reputation. For these reasons, it is socially optimal for small, new firms to be faced with higher finance costs. While these economic facts of life may be irksome to the owners of such firms, they are entirely consistent—at least qualitatively—with the Paretian concept of efficiency.

Finally, the empirical work discussed in this paper presents a challenge to those who hold the view that the reluctance of banks to lend to small (or, more accurately, new) firms is evidence of imperfection in LDC finance markets. It has shown that there are

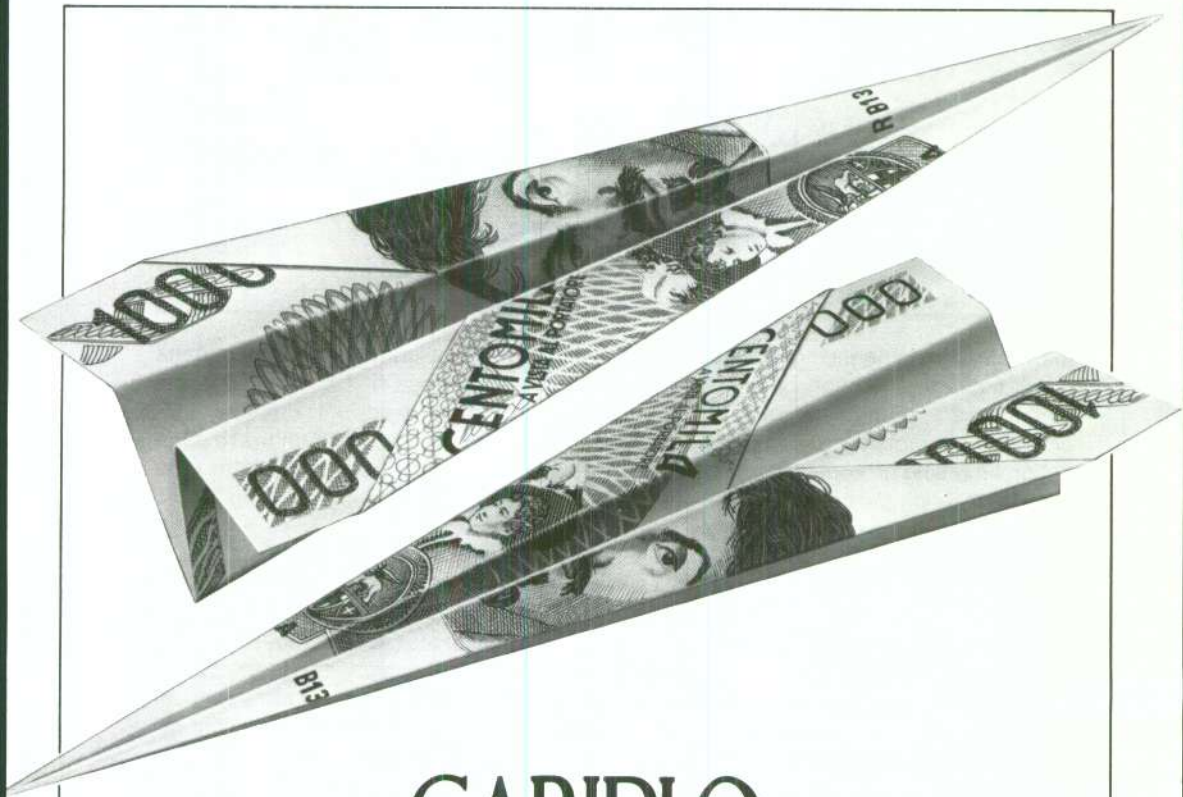
20 According to the 1974-75 Census of manufacturing firms, if the output of "cottage" firms (those with less than 5 employees) is excluded, about 42 per cent of value-added was produced by firms with from 5 to 99 employees. No data are available for other sectors, but it would be reasonable to assume that average firm size was smaller in the serviced sector so that the relative importance of small firms would have been even greater. (Data from Census kindly supplied by Dr Peter McCawley)

many competing financing arrangements for such firms—including the supply of bank credit indirectly, through other, often larger firms—and argued that banks often find themselves at a competitive disadvantage. If this argument is correct, it follows that empirical attempts to validate the imperfections hypothesis must focus on these competing financing arrangements rather than the banks. To concentrate on the latter—as has largely been the case hitherto—is simply to ignore everything relevant to the issue.

Abstract

This paper discusses a study of the financing of small businesses in Indonesia, which was intended to shed some empirical light on the view that conditions in the finance markets in less-developed countries hinder small firms' access to external funds, seriously constraining their growth. It is argued that there is no convincing evidence that orthodox lending practices of financial institutions in respect of small firms are socially non-optimal.

The paper introduces and elaborates the concept of "financial evolution of firms" that is, the notion that their range of financing options tends to widen over time, resulting in a concomitant reduction in the overall cost of finance. Obtaining finance is regarded as just one item in a long list of challenges to be faced by the entrepreneur during the attempted exploitation of opportunities for profit. Thus it seems much more plausible to argue that lack of entrepreneurial ability makes access to finance difficult, rather than that lack of access to finance holds back entrepreneurship.



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