

THE NON-INSTITUTIONAL FINANCIAL SECTOR IN DEVELOPING COUNTRIES: MACROECONOMIC IMPLICATIONS FOR SAVINGS POLICIES (*)

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1. Introduction

The bulk of the literature on this subject has been microeconomic and sectoral and has tended to concentrate on the structure and operations of the non-institutional financial sector. The macroeconomic aspects are particularly relevant insofar as they affect the mobilization and allocation of personal savings. This paper attempts to analyse the macroeconomic implications of the non-institutional financial sector in developing countries and to suggest appropriate techniques and policies for strengthening its links with institutional finance.

The non-institutional financial sector, also referred to as the unorganized or informal sector, covers all financial activities outside the ambit of institutional finance. It is a heterogeneous residual sector comprising different entities, such as money lenders, traders, landlords, pawn brokers, friends, and relatives. Consequently, it is difficult to give a clearcut logical definition of the sector, which is better identified by its dominant characteristics such as ease of entry and exit, informality of transactions and smallness of scale. The term « informal » is arguably more logical than either « unorganized » (since it can be as organized in its own way as the organized sector) or « non-institutional » (since there are also institutions in the noninstitutional sector). Its distinguishing characteristic, which constitutes its primary economic rationale, is the informal nature of its financial activities which confers differential economic advantages over the institutional sector. This also explains why the term informal sector has come to be the established term of art rather than non-institutional or unorganized sector¹. But much of the discussion has related largely to the output and employment aspects of the urban informal sector rather than of the informal sector as a whole or of its financial aspects². The institutional/noninstitutional, or formal/informal dichotomy has gradually

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1. The term « informal sector » was evidently first used by Keith Hart in his study « Informal Income Opportunities and Urban Employment in Ghana », *The Journal of Modern African Studies*, March 1973, pp. 61-89 and subsequently developed in the ILO/UNDP Report on *Employment, Incomes, and Equality: A Strategy for Increasing Productive Employment in Kenya* (Ghana, 1972).

2. Cf. S.V. Sethuraman, « The Urban Informal Sector: Concept, Measurement and Policy », *International Labour Review*, July-August 1976; John Weeks, « Policies for Expanding Employment in the Informal Urban

superseded the more conventional categories of economic dualism based on the urban/rural, traditional/modern, or market/subsistence sectors. The formal/informal classification is analytically more comprehensive since it cuts across the locational basis so strongly characteristic of the conventional dualistic sectors. The financial sector in developing economies is best regarded as a continuum with varying elements of both sectors.

However, because of its amorphous character there has been no explicit measurement of the size and flows in the informal sector in the national accounts of developing countries. Even if rough estimates of orders of magnitude could be made for some base year, it would be difficult to gauge the subsequent annual movements³. In terms of financial activity, the informal sector is generally more important in the rural sector, except in a few countries such as Korea where the unorganized urban financial market is much larger.

Although there are no estimates of the size and activity of the informal sector as a whole in LDCs, there is reason to believe that it is more significant than its physical output potential would suggest⁴. The available estimates of the relative size of the non-institutional financial sector in developing countries also confirm this (see Tables 1 and 2). The results of two pioneering surveys, two decades apart, point to the following broad conclusions⁵:

(a) Non-institutional finance is still much more important in Africa, Asia, and the Middle East and it is only in Latin America that institutional sources are more significant than non-institutional sources.

(b) The size of the non-institutional sector, measured by the ratio of rural indebtedness to the claims of the banking system on the private sector, was larger than the institutional sector in about half of the sample of 16 countries in the 1950s, while in the

Sector of Developing Economies », *International Labour Review*, January 1975, pp. 3-4; « The Urban Informal Sector: Critical Perspectives », *World Development*, September/October 1978; Ray Bromley, « Introduction - The Urban Informal Sector: Why is it Worth Discussing? », *World Development*, op. cit., p. 1032.

3 D.G. Clarke, « The Urban Informal Sector and National Accounting », *Development and Change*, The Hague, Vol. V, 1973-74, No. 1, pp. 54-57; and B. Van Arkadie, Reply to D.G. Clarke, *Ibid.*, pp. 58-59.

4 Joan Robinson makes the point that the informal sector contributes little to physical production. See *Aspects of Development and Underdevelopment*, Modern Cambridge Economics Series, Cambridge University Press, 1979.

5 U Tun Wai, « The Role of Unorganized Financial Markets in Economic Development and in the Formulation of Monetary Policy », *Savings and Development*, No. 4, 1980-IV, p. 259.

Table 1
INDICATORS OF THE RELATIVE SIZE OF THE
UNORGANIZED MONEY MARKET

Agricultural Indebtedness as Percent of					
Region and country	Latest year	Claims of banking system of private sector	Currency in circulation	Income originating in agricultural sector	National income
<i>Asia</i>					
India	1969-70	108	131	...	13
Korea	1964	87	195	15	8
Nepal	1970	175	85	7	5
Pakistan	1971	126	197	...	33
Philippines	1969	78	276	60	21
South Viet Nam	1967-68	82	35	24	7
Sri Lanka	1969	84	112	30	12
Taiwan	1970	29	136	62	11
Thailand	1970	30	71	17	7
Mean		89	138	31	13
Median		84	131	24	11
<i>Latin America</i>					
Brazil	1968	39	187	55	10
Chile	1969	37	95	49	4
Costa Rica	1964-65	86	338	82	25
Ecuador	1966	31	81	...	6
Mexico	1966	66	109	...	6
Mean		52	162	62	10
Median		39	109	55	6
<i>Middle East</i>					
Afghanistan	1971-72	12	6
Iran	1970-71	63	301	63	16
Turkey	1967	55	168	46	17
Mean		43	158	54	16
Median		55	168
<i>All countries</i>					
Mean		70	148	42	12
Median		66	131	48	10

Source: U Tun Wai, "A Revisit to Interest Rates Outside the Organized Money Markets of Underdeveloped Countries", *Quarterly Review*, Banca Nazionale del Lavoro, No. 122, September 1977, p. 292.

Table 2COMMERCIAL BANK CREDIT TO AGRICULTURE AS PERCENT OF TOTAL BANK CREDIT TO THE PRIVATE SECTOR¹

Region	Percent
Africa (29 countries) ²	
Mean	14.7
Median	9.4
Asia (12 countries) ³	
Mean	8.0
Median	7.2
Latin America (20 countries) ⁴	
Mean	13.9
Median	10.9
Middle East (9 countries) ⁵	
Mean	10.0
Median	8.9
All countries (70)	
Mean	12.7
Median	9.2

Source: U Tun Wai, *Ibid.*, p. 296.

1 Latest available date during the period 1971-73.

2 Algeria, Benin, Burkina Faso, Cameroon, Central African Republic, People's Republic of Congo, Gabon, Ghana, Ivory Coast, Kenya, Lesotho, Liberia, Malagassy Republic, Malawi, Mali, Mauritania, Mauritius, Niger, Nigeria, Rwanda, Senegal, Sierra Leone, Somalia, Tanzania, Togo, Tunisia, Uganda, Zaire, and Zambia.

3 Burma, Fiji, India, Korea, Malaysia, Nepal, Pakistan, the Philippines, Singapore, Sri Lanka, Taiwan, Thailand.

4 Barbados, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Guyana, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Surinam, and Trinidad and Tobago.

5 Cyprus, Egypt, Ethiopia, Iran, Iraq, Jordan, Libya, Syria, and Turkey.

1970s in only three countries out of a sample of 17 countries unorganized financial markets were larger than organized ones. In about one half of the countries, unorganized markets were at least three fourths as large as the organized markets.

(c) Based on a sample of 15 countries in the 1970s, about one third of non-institutional credit was for consumption purposes and about 20 percent for agricultural investment.

2. The Nature and Characteristics of the Non-Institutional Financial Sector

Given the difficulties of measuring the size and flows in the informal financial sector, it is more fruitful to identify its significant characteristics.

2.1. *Organizational*

The ownership and control of the constituent entities is typically either (i) proprietary (e.g., money lenders, pawn brokers, and indigenous bankers) with ownership being vested in individual or family businesses; or (ii) mutual (the rotating savings and credit associations (ROSCAS) prevailing in Africa (see Table 3), Asia (e.g., the *nidhis* and *chit* funds in India, the *Kyes* in Korea), and Caribbean (e.g., the partner system in Jamaica). The average scale of operations is smaller than in the institutional sector, and the overheads in terms of staff, premises, and equipment are also low and minimal; (iii) the formal requirements of registration are minimal, nonexistent, or are evaded. There is complete freedom and ease of entry and exit which creates an important condition for perfectly contestable markets, viz., of « costlessly reversible entry »⁶. The ROSCAS imply rotating access to a continually reconstituted capital fund bases on fixed contributions from each member and/or distribution at fixed intervals and as a whole to each member in turn by lot, agreement, or bidding (auctions). There is arguably no element of explicit interest.

2.2. *Functional and Operational*

(i) The costs of transactions and information are low because of the informality of transactions (minimal or no documentary credits except for promissory notes, post dated checks, or indigenous bills of exchange) and the intimate knowledge of customers on the part of lenders. It has been rightly said that « credit markets in underdeveloped countries often strongly reflect the operation of the Lemons Principle », i.e., of economic models in which « trust » and first hand knowledge of customers is important⁷.

6 William J. Baumol, John C. Panzar, and Robert D. Willig, *Contestable Markets and the Theory of Industry Structure*, Harcourt Brace Jovanovich, New York, 1982, p. XIX.

7 George A. Akerlof, « The Market for "Lemons": Quality Uncertainty and the Market Mechanism », *The Quarterly Journal of Economics*, August 1970, p. 497.

Table 3

INFORMAL SAVINGS AND LOAN ASSOCIATIONS IN AFRICA

Country	Local Name	Selected Organizational Characteristics
Liberia	Esusu	Fund (collective deposit) rotates
Gambia	Osusu	
Sierra Leone	Asusu	
Senegal	Tontine	Fund rotates
Ivory Coast	Diaou moni, wari moni	
Ghana	Nanemei akpee	Fund rotates, reported for women traders
Ghana	...	Fund does not rotate; used by fish traders to control fish supply
Benin	Ndjonu, tontine	Fund does not rotate
Nigeria	Esusu, isusu, dashi, adashi, oha, bam	Fund rotates in some group but not others; some groups have both a rotating and a nonrotating fund
Nigeria	Osus, contributions club, meeting	Fund does not rotate
Niger	Asusu	
Cameroon	Njangi, djanggi, tontine, credit rings	Fund rotates
Cameroon	Meeting, « bank »	Fund is fixed
Cameroon	Mandjon	Group pools funds for investments
Zaire	Ikelemba, kitemo, osassa	Fund rotates
Congo (Brazzaville)	Temo	...
Sudan	Sandukm khatta	...
Ethiopia	Ekub, ikub	Fund rotates
Kenya	...	
Uganda	Chilemba	Fund rotates in some groups
Tanzania	...	
Zambia	Chilemba	
Rhodesia	Chilemba	Fund rotates
Malawi		
Rep. of South Africa	Umagelo clubs, mahodisana, stok-fel	
Egypt	Gameya	...

Source: Adapted from Marvin P. Miracle, Diane S. Miracle, and Laurie Cohen, « Informal Savings Mobilization in Africa », *Economic Development and Cultural Change*, July 1980, p. 705.

(ii) Loan transactions are more dominant than deposit transaction and most of the lenders operate with their own savings and capital.

(iii) Freedom from de jure and de facto central banking controls on lending and borrowing such as cash reserve and liquidity ratios, interest rate and portfolio ceilings, selective credit controls, moral suasion, etc.

Table 4

USES OF FUNDS REPORTED IN THE LITERATURE:
QUALITATIVE DATA

Use	Sierra Leone	Liberia	Ghana	Benin	Nigeria	Niger	Cameroon	Zaire	Congo (Brazzaville)	Ethiopia	Zambia	Malawi	Sudan	Republic of South Africa
Trade ¹	X	X	X	X	X		X	X		X	X			X
Acreage expansion	X	X		X			X	X						
= Property =				X										X
Buses, trucks, or taxis		X		X			X	X		X				
Bicycles for business					X									
Canoes			X											
Palm groves					X									
Fish nets			X											
Grain grinding mill				X										
= Tools =					X									
Seed				X	X	X				X	X			
Fertilizer				X			X				X			
Hire labor														
Roads, schools, or hospitals		X			X		X			X				
Livestock				X						X				
Education					X		X							
Bridewealth		X		X	X		X	X	X			X		
Taxes					X									
Collateral for loan					X									
Build houses (use unspecified)			X	X	X		X		X	X				
Improve houses ²		X		X			X		X					
Litigation					X									
Travel (purpose not specified)								X						
Food or clothing	X				X	X	X	X	X	X				
Bicycles (use unspecified)				X	X		X					X		
Sewing machines												X		
Radios		X		X										
Jewelry													X	
Ceremonies (including funerals)		X		X	X		X	X						
Parties & other entertainment		X			X		X			X				
Medical expenses			X				X							

Source: Marvin P. Miracle, Diane S. Miracle, and Laurie Cohen, *Ibid.*, p. 716.

1 Includes = buy trade goods =, = finance new business =, and = build rental houses =.

2 Provision of a metal roof specifically mentioned for Benin and Cameroon.

(iv) Effective rates of interest are higher than in the institutional sector and often exceed the ceilings under usury laws which in any event are difficult to implement and monitor. The prevalence of usurious rates of interest suggests that availability rather than the cost of credit is the more relevant variable. This feature points to an interesting paradox: unlike the real informal sector which provides nonfinancial goods and services at relatively low prices to consumers, the informal financial sector provides high priced financial services to borrowers.

(v) The informal sector escapes the implicit taxation of the institutional sector through government preemption of funds at controlled, i.e., below equilibrium rates of interest and the subsidized borrowing of the institutional sector.

(vi) The end-uses of informal credit are a mixture of consumption and investment credit with the former more prominent than is usual with institutional credit (see Table 4).

Some of these factors (2.1.iii and 2.2.iii, iv and v) eliminate a large part of the so-called financial repression of the institutional sector and give rise to elements of perfect competition and confer a comparative advantage to the non-institutional sector. On the other hand, there is a considerable degree of oligopolyoligopsony among lenders due to their combination of money-lending and trading functions, which also detracts from the otherwise strongly competitive nature of the market. Consequently the informal financial sector presents a paradoxical combination of both highly competitive, as well as oligopolistic elements.

3. Interest Rates in the Non-Institutional Sector

The level of interest rates charged by non-institutional lenders is said to have declined from an average of about 40 percent in the 1950s to an average 30 percent per annum in the 1970s based on a sample of 13 countries (Ethiopia, Nigeria, and Zambia; India, Korea, Nepal, Pakistan, South Viet Nam, Sri Lanka, and Thailand; Brazil, Chile, and Ecuador; and Iran). Over the 20-year period, the gap between the interest rates in the non-institutional and institutional sectors has narrowed because of improved links between the two sectors and an increase in the rates in the organized sector⁸.

It is pertinent to note that some of the nominally high rates of interest (even up to 300 percent per annum), which are often cited in the literature overstate the real price of

8 See U Tun Wai, 1980, *op. cit.*, p. 260.

loanable funds in the noninstitutional sector. This is because « nominal interest... at fantastic levels... is mainly a device to keep the peasants permanently in debt. The actual payments exacted cannot exceed the margin between subsistence and rent »⁹. The high rates are exclusively lenders' rates since moneylenders usually do not accept deposits and these rates therefore have little influence on the propensity of the informal sector to save. The high lending rates are a device to maximize the current income of the lender who is more concerned to maximize and ensure payment of interest than to amortize the principal. If the nominal rate of interest could be decomposed into its main constituents, namely, (1) the liquidity premium, (i.e., the pure rate of interest); (2) the risk premium (i.e., to cover risks of defaults and shortage of collateral); (3) costs of administration; and (4) the residual comprising various institutional factors such as lender's monopoly, combination of lending and trading, market imperfections, etc., the residual would outweigh the aggregate of the first three factors. There are no systematic tests of such hypotheses. However, according to one estimate, about one-sixth of the 29 percentage point difference between institutional rates (averaging 11 percent) and non-institutional rates (averaging 40 per cent) is due to defaults and risk factors; one-sixth due to monopoly profits; and one-third each due to the willingness of borrowers to pay high rates and to factors such as inadequate collateral and high opportunity costs for money lenders¹⁰. In fact if one deducts one-sixth of the differential attributable to defaults and risk, the remaining factors are largely institutional. There is thus considerable justification for the view that « the most important influences upon interest rates—which account for, say, the difference between 30 percent in an Indian village and 3 percent in London — are social, legal, and institutional »¹¹.

4. Implications for Monetary Policy and Savings Mobilization

It is important to recognize that the formal and informal financial sectors are not really independent non-competing groups. Although the links between these sectors are relatively weak in most countries, they nevertheless exist insofar as non-institutional len-

9 Joan Robinson, *The Accumulation of Capital*, Macmillan, London, p. 290.

10 U Tun Wai, 1980, *Ibid.*, p. 260.

11 Joan Robinson, « The Rate of Interest », *Collected Economic Papers*, Oxford, Vol. II, 1960, p. 246.

ders borrow from organized money markets and commercial banks¹². Consequently, any tightening or relaxation of credit policy would have some impact on the availability of credit in the informal sector but not necessarily on the cost of that credit (interest rates) given the semi-monopolistic positions of lenders in this sector. Likewise, an increase in rates in the institutional sector is known to result in an inflow of savings from the non-institutional sector as for instance, in Korea after the interest rate reforms of 1965. The institutional sector's excess demand for credit spills over into the non-institutional sector. This may happen because, among others, borrowers may have exhausted their ability to provide collateral whereas non-institutional lenders do not usually require such collateral which may instead take the form of promissory notes, indigenous bills of exchange, or post-dated checks. Thus the non-institutional sector acts as a vehicle of disintermediation, i.e., borrowing or lending outside the non-institutional sector, which may be reflected in one more of the following channels: (1) intercompany borrowing or lending; (2) sale by banks of assets on repurchase agreements to the private non-banking sector; (3) increase in the utilization of acceptance facilities and the rediscounting of such acceptances outside the institutional sector by companies seeking to reinvest their liquid funds; and (4) discounting of bank endorsed trade bills with large depositors rather than by banks for their own accounts.

The disintermediation caused by such factors erodes the efficacy of monetary policy and results in the fragmentation of the money and capital markets and impedes the efficient mobilization and allocation of savings. Generally the liabilities of the non-institutional sector do not partake of the characteristics of money and given the predominance of currency in its transactions this sector does not experience a large « return flow » in the form of deposits when it extends credit. There is consequently a considerable dampening of the money multiplier. The non-institutional sector also reflects the

12 Cf. « The money market controlled by the top Indian bankers... was as well organized in its own way as that organized through Europeanstyle institutions. In the sense of linking up the network of large Indian bankers with that of joint-stock banks, this integration was largely achieved by the 1870s... However, their integration simply meant that joint-stock banks had a share in the profits made by Indian bankers in their roles as financiers of trade, of zamindars and of peasants subsistence. It had no noticeable influence on the exorbitant rates of interest paid by peasants, artisans and workers, for they were linked to the fundamental forces determining the rate of exploitation rather than to purely monetary phenomena. The investigation of the exact reasons for the failure of the alleged effects of "integration" to materialize is yet to be studied by economists and historians ». A.K. Bagchi, « Money and Credit as Areas of Conflict in Colonial India », *Eighth International Economic History Congress*, Budapest, 1982, p. 234.

workings of the so-called "underground economy" which emerges as a mechanism to evade taxes and controls¹³.

5. Links between the Institutional and Non-Institutional Financial Sectors

The general bias of policy in developing countries ranges from studied neglect to active hostility towards the non-institutional sector. This seems misconceived considering that the size and persistence of this sector testifies, if anything, to its inherent strength and economic rationale. Attempts to formalize the informal sector are liable to fail because its very rationale derives from its informality. Excessive regulation of the informal sector is more likely to result in its disappearance without providing for adequate institutional substitutes. The appropriate strategy should therefore be for the institutional sector to take on more of the desirable features of the informal sector particularly in relation to the small saver and small borrower. Some of the elements of such a program would be as follows:

- (i) Creation of a panel of guarantee brokers (i.e., like the *compradores* of the foreign banks in South East Asia) attached to each commercial bank. These brokers, who would be drawn from the ranks of non-institutional lenders, could work on a salary cum-commission basis to guarantee loans to small and risky customers.
- (ii) Creation of credit risks insurance system in the institutional sector to insure loans to small or risky customers (on the lines of the systems in India and Malaysia).
- (iii) Provision of central bank rediscount or refinance facilities for credit instruments of the informal sector subject to a guarantee by authorized brokers that it is not accommodation paper and represents genuine credit.
- (iv) Institutional lenders, particularly rural cooperatives, should earmark a certain proportion of their credit for essential consumption purposes. (The Sivaraman Committee (1976) on Rural Credit in India had recommended that rural credit cooperatives should earmark a specified portion of credit for essential consumption purposes).
- (v) Lending procedures, including hours of work of the institutional lenders should become more flexible and informal and the social, cultural, and psychological attitudes of bank staff should be more in tune with the local environment and the needs of the local community.

13 See Vito Tanzi, "The Underground Economy", *Finance and Development*, December 1983.

To conclude, developing countries will need to evolve an intermediate financial technology through which an expanding institutional sector will incorporate the more attractive features of the informal sector, notably its flexibility of lending procedures and greater reliance on project viability rather than collateral. However, the issues relating to the non-institutional financial sector involve « somewhat more complex considerations than that of misallocation of resources, per se, particularly for developing countries where « excessive regulation of the economy has at times brought about excessive rigidities, [and] the underground economy, which in this case might be more properly called "the parallel" economy, has often made a difference between a relatively viable economy and a stagnating one »¹⁴.

LE SECTEUR FINANCIER NON FORMEL DANS LES PAYS EN VOIE DE DÉVELOPPEMENT: CONSÉQUENCES MACROÉCONOMIQUES SUR LA POLITIQUE DE MOBILISATION DE L'ÉPARGNE.

RÉSUMÉ

Cet article analyse certaines conséquences macroéconomiques les plus importantes sur les politiques de mobilisation de l'épargne du secteur financier non formel dans les P.V.D. Etant donné le degré élevé d'hétérogénéité de ce secteur (comprenant différentes catégories d'opérateurs telles que les prêteurs d'argent, les banques d'origine locale, les tontines, les propriétaires fonciers, les commerçants, les prêteurs sur gages, etc.) il est difficile de le définir d'une façon précise. On peut l'identifier de façon plus adéquate en prenant en considération ses caractéristiques plus marquantes telles que la non formalité des transactions, la manque de réglementation, les taux d'intérêt usuriers, la prédominance du crédit à la consommation et la faible dimension des opérations financières. On ne possède pas d'estimations complètes en ce qui concerne la dimension et les activités du secteur financier informel dans les P.V.D. Toutefois des données à notre disposition, quoique incomplètes, montrent que ce secteur est plus important en Afrique, en Asie et au Moyen-Orient qu'en Amérique Latine. Il agit comme instrument de disintermédiation financière et tend à réduire l'efficacité des politiques monétaires et de l'épargne.

¹⁴ See Tanzi, *Ibid.*, p. 13.

L'existence du secteur financier non formel montre son degré de rationalité économique et présente des avantages comparatifs avec le secteur formel. Il ne faut donc pas s'étonner si les différentes tentatives de le réglementer peuvent aboutir à des effets négatifs. La stratégie la plus adéquate devrait être plutôt recherchée dans la modification de certaines caractéristiques du secteur formel. Ce secteur devrait assumer les caractéristiques les plus désirables du secteur non formel telles que la flexibilité des procédures de prêt et la concentration de l'attention sur la rentabilité des projets. Dans ce contexte un facteur important peut être recherché dans l'action de la banque centrale visant à accorder des facilités de réescompte et d'autres opérations similaires.

