

# EVOLUTION OF RURAL INFORMAL FINANCIAL INSTITUTIONS IN SOUTH ASIA

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## 1. Introduction

Credit is an essential link of the rural economy. Sharecropping contracts fertility decisions, savings behavior, technological innovation and economic inequality are only a few important examples of the wide range of phenomena that are likely to be closely affected by borrowing and lending opportunities. An adequate understanding of rural credit is a crucial ingredient of economic policy and public action in many fields.

Unfortunately, credit is one of the least confidently aspects of the rural economy in Eastern India, Bangladesh and Nepal. One reason for this is the dearth of careful empirical studies on rural credit. It is imperative to mention here that there is a significant difference between the concept of micro credit (or micro finance) and farm credit through informal channels. Micro finance products aimed primarily at micro-entrepreneurs, especially market vendors, with short loan terms, regular repayment schedules and ever increasing loan amounts. The target clients are skilled non-farmers. The poor and marginal farmers on the other extreme also need credit at different points of time, starting from sowing to harvest time. Here also the informal sector plays a useful role.

This paper attempts to discuss the evolution of informal rural farm-credit institutions in South Asia. The literatures in this context are elaborated in Section 1. Section 2 briefly describes some of the salient features of informal credit market. Section 3 closes with a discussion of some of the relevant evidence, which establishes the empirical importance of interlinking. Finally, Section 4 assesses the potential role of these markets in developing finance.

## 2. Farmer's Choice of Loan and Technological Innovation

The pattern and consequences of interlinked credit markets have been a subject of controversy for quite some time. Bhaduri's model (Bhaduri 1973) focused that the landlords have two sources of income: rent and usury. Their share of the crop is fixed by law, but in addition they exploit their tenants through consumption loans which keep them in a state of perpetual indebtedness. The landlords block any technological changes which, by increasing output and hence tenants incomes (by virtue of the

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assumed fixity of shares), would either reduce their usury income by a greater amount than their gain from the increased output, or would free their tenants from the indebtedness that forms the basis of the landlords economic power. Bhaduri's model has been criticized on several grounds. First, his assumption of fixed shares is questionable: especially if nominal shares are fixed by law or custom, the distribution of net output between landlord and tenant can be altered in a variety of ways, for example by altering cost sharing terms, demanding additional (possible illegal) payments or raising interest rates on loans.

Second, as Ghose and Saith (1976) have pointed out, Bhaduri's model rest on the peculiar assumption of perpetual but stationary debt. Perpetual indebtedness could persist after the adoption of new technology even if the crop shares remain unchanged. Third, Bardhan and Rudra (1978) demonstrate that the model's assumption that tenants receive usurious loans from, and only from, their own landlords is not empirically supported in Eastern India. Fourth, the dynamic implications on Bhaduri's model are doubtful propositions. If usurious loans impede technological change, this would suggests that the landlords happen to be resident and money lenders (Basu 1990). Likewise, Braverman and Srinivasan (1981) and Braverman and Stiglitz (1982) using Bhaduri's contention that innovation leads to lower demand for credit, have shown that there is no presumption that innovation results either in a reduction or in an increase in tenant's demand for credit.

Therefore, entry into the informal credit market is not restricted. In fact there appears to be relatively free entry into money-lending and this keeps rates commensurate with costs. Mellor (1966) observes that various land owning and agricultural castes engage in money-lending in much of rural India, and the requisites are simply a small sum of credit, business acumen, and a willingness to take the necessary risks.

But the entry of potential borrowers to sources of credit is highly restricted. Rudra (1982) mentioned that the money-lending business cannot be conducted except on the basis of some means whereby the creditor can secure repayment of loan. The standard way is the practice of mortgaging and the objects for mortgage are land, jewelry (for those who possess it) and brass/bell-metal utensils. But the greater part of the population does not have land or any other assets at all. Another point to be mentioned here is that adequate and timely supply of credit to the farmers is not possible even with the existence of formal credit institutions.

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Note that the adoption of HYV Technology raises the working capital requirements for cultivation as the farmers have to pay for fertilizers and irrigation charges before they reap the harvest. This cost however cannot usually be covered through institutional credit as these are riddled with bureaucratic formalities.

### 3. Interlinked Transactions

In the rural economy, people know a good deal about the business of others, and when prices do not reveal all relevant information, it is usually in their interest to do so. Thus, if two people from the same locality trade with each other in two or more markets, it is pertinent to ask whether they do so deliberately rather than purely by chance, and if deliberately, for what reasons and with what consequences. Thus, we define an interlinked transaction is one in which the two parties trade in at least two markets on the condition that the terms of all such trades are jointly determined.

Loosely speaking, there is a "package" or "bundled" deal, in which each element in the deal is connected to every other in an essential way. It is to be mentioned here that interlinkage is one of the most important mechanisms for reducing transaction costs and risk premia. There is evidence that interlinked credit is more important than non-interlinked credit.

The major source of interlinked credit and of all rural informal credit in many countries may now be lenders who lend as part of their product market transactions. Thus, traditional moneylenders seem to be declining, although there is evidence in some countries that salaried employees are replacing them. Our observation is consistent with Islam and Rahman (1985) in the context of Bangladesh. To quote: "In Bangladesh, friends, relatives, and well-to-do neighbours constitute the largest source of lenders".

However, not all credit from these sources are "non-commercial" in the sense of being interest free. In fact interest rates charged by friends and relatives are often no different from those charged by other lenders, while the personal relationship make transaction possible by serving as collateral.

In view of data limitations there has been a dearth of empirically tested model of high interest rate prevailing in the informal credit markets in LDCs'. It is to be mentioned here that most of the informal lenders operate in a limited area or in a specific

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niche of the market where personal knowledge of borrowers makes transactions possible. This enables informal lenders to reduce transaction costs (e.g., those relating to loan appraisal, documentation and legal fees) to a minimum. It is characterized by a much shorter processing time, better screening techniques or enforcement devices and higher interest rates, with a median around 50 percent and a variance much higher than institutional credit rate.

Lack of integration among rural credit markets is often held as a major cause of high interest rate in LDCs as within each fragment the market is monopolistic (Basu, *op. cit.*). This case is demonstrated by the example of interlinkage practices, frequently observed in rural areas. Credit contracts between farmers and lenders are often in the form of production loans and tied to the purchase of fertilizers, seed, output and other forms of capital, with different farmers paying different interest rates on their loans.

### 3.1 Evidence

In this section, we shall discuss:

- i. the relative importance of sources of funds
- ii. the terms on which credit is secured
- iii. market structure and
- iv. the extent to which dealings in the credit market are tied to those in other markets.

In a landmark study of 9000 families in 1951/52, the Reserve Bank of India (1954) found that during the year surveyed, 93 percent of the total amount borrowed by cultivators was supplied by private parties, excluding the commercial banks, which accounted for about 1 percent. The residual came from government and cooperatives in roughly equal amounts. Among private parties, the professional moneylender and the agriculturist moneylender accounted for 45 and 25 percent, respectively, of the whole. Relatives (14 percent), landlords (2 percent) and traders and commission agents (6 percent) made up the rest. Twenty years later, the professional moneylender had fallen from his pre-eminent position to a share of just 13 percent, while agriculturist moneylenders, landlords and traders and commission agents had raised their combined share to 40 percent. It is important to note, however, that lending is rarely the moneylenders' only line of business. In the early 1950s, a very high proportion of lenders were cultivators and/or traders of some kind. Thus the decline of the professional moneylender may be more apparent than real. In any event, there has been a great expansion of lending by the cooperatives and the banks, which reflected the govern-

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ment's aim of competing with the moneylender, ultimately to drive him out of business.

Another decade later, a study of 34 village in three diverse States – Andhra Pradesh (transition), Bihar (backward) and Punjab (commercialized) – revealed that institutions were still gaining at the expense of private parties, the shares of the former in total lending being 33, 34 and 51 percent, respectively (Bell and Srinivasan 1985).

An important related question is the extent to which households participate in the institutional and informal segments of the credit market. From Table 1 it appears that access to institutional credit in the more backward areas of India is very limited indeed. However, as the institutions share of total lending is about one-third of the whole, those who do obtain institutional credit get far longer loans on average than those who borrow from private sources.

**Table 1:** *Participation in the Credit Market (proportion of all households)*

State/source	Informal only	Institutional only	Both	Neither	Total
Andhra Pradesh	30	5	2	63	100
Bihar	40	6	2	52	100
Punjab	28	12	19	41	100

Source: Bell and Srinivasan (1985)

Where the terms of credit are concerned, there seems to be some uniformity. In the period before independence, the annual rate of loans secured against land was commonly 12 percent, but somewhat higher in the eastern states (Darling 1925). The rate on unsecured loans was naturally higher, but also somewhat more variable.

In Bangladesh small farmers are left with the option of either borrowing from the informal credit market or drawing upon their own meager resources. In the first case, they are usually forced to pay an exorbitant rate of interest and in the second, they apply high subjective rates of discount on future income in view of their subsistence level of present consumption (Hossain 1989).

In a series of notable papers, Bardhan and Rudra (1978, 1981) examine the prevalence of various forms of interlinking in eastern India in the period 1975 through 1979. Overall, about two-thirds of all landlords were reported to have cultivation as their principal occupation; trade and then money lending managed barely 10 percent between them. In this respect, the divergence between "advanced" and "backward" villages was sharper still. Nevertheless, the landlord was an important source of credit



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to his tenants. Consumption loans were made in about one-half to tenancy contracts, and production loans in almost 45 percent, the latter being much more prevalent in advanced than backward areas. Where labour services are concerned, only 10-15 percent of landed tenants reported rendering them to landlords, but the proportion among landless tenants was one-half or more, and by no means confined to backward areas. In any event, a majority of those who did work for their landlords claimed to have been "properly" paid. Turning to labour contracts proper, Bardhan and Rudra found rather few instances of debt - peonage, which was reported in 7 percent of the villages surveyed. Aside from bonded labour, the great majority of attached farm servants took consumption loans from their employers, while about one-third of casual labourers did so (the proportion rose in the east).

In a re-survey of the same village, Dreze and Mukherjee (1987) found that the 67 households supplying some casual labour in the course of the season, 19 were free of debt and 16 of those in debt worked for their creditors. Similarly, of the 110 households involved in tenancy, 23 reported credit dealings with the other party to the tenancy contract.

Investigating the same matter, Bell and Srinivasan (*op. cit.*) found that links between credit and marketing were far more prevalent and significant, in terms of the volume of credit, than those between credit and tenancy or labour. A summary of their findings is presented in Table 2, from which it is also clear that households borrowing from commission agents or traders obtained, on average, much larger loans than did workers from employers or tenants from landlords, or even those who had no other dealings with their creditors. Moreover, links between credit and output were strongest in the more commercialized areas. On reflection, this is hardly surprising since traders and commission agents will seek out business - and seal it with finance - where there is a substantial marketable surplus. Hence, finance follows trade to commercialized areas and, in particular, to the door of the big farmer are neglected. Taken together, these studies suggest that interlinking is not, as some would argue, a remnant of a semi-feudal mode of production, but rather a flexible market response to growing commercialization.

In a study of 200 rural households in Orissa, in the late seventies, Sarap (1986) found variety of interlinked credit transactions. It is evident from Table 3 that the proportion of linked borrowers is understandably higher among the landless households and generally falls with the increase in size of holding. Thus, tying of credit with input

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and output transactions is the dominant form of interlinking among small form households followed by credit and output and by labour tying.

**Table 2: The Extent of Tying between Credit and Other Markets<sup>a</sup>**

	No tie	Tenancy alone	Output	Labour alone	Combination	Total
Andhra Pradesh	62.0 1355	6 463	20.0 1387	16.9 230	1.1 264	100 1188
Bihar	63.8 494	10.6 121	1.2 1166	8.3 296	16.1 72	100 434
Punjab	56.9 1155	3.8 551	30.6 5000	3.9 662	4.8 829	100 1838

<sup>a</sup> The upper number in each cell is the proportion of all borrowing households falling into the category in question; the lower is the average amount borrowed in Rs.

<sup>b</sup> Smaller than 0.1 percent.

Source: Bell and Srinivasan (1985)

Interestingly, there is some evidence that the same forces work in Bangladesh. As for example, Banik (1993) found a variety of linked credit transactions involving credit land (*bandhaki/daisudi*), credit-land tenure (*Challani*), credit-crop (*dadani*) and crop-crop (*hawlia*).

This can be revealed in Table 4. Based on field work in two villages of Bangladesh, Banik, reported that the need felt by small farmers to enhance their liquidity is the main reason that drives them to lease out land to other farmers through an arrangement called *bandhaki*. The arrangement involves the transfer of land rights only for varying lengths of time, ranging from the crop season to several years. The land is, however, often cultivated by the lessor and half the share of the product goes to the lessee as implicit interest. A landlord-lessor also makes production or consumption loans to his tenant. This is known as *challani*. It is, however, to be mentioned that interlinkage in this case may have benign effects. This is not unusual as the main motivation is to ensure that tenant applies the optimum amount of inputs including the amount of work effort to the mutual benefit. In regard to interlinkage between credit and produce markets, there have been cases of credit being used to purchase inputs or pay bills to wage labourer.

**Table 3: Types of Interlinked Credit Transactions among Landless Labour and Small Farm Households in Irrigated and Non-irrigated Area of Sambalpur: 1980-81**

Household Category	Type of Linkage	Total No. of Borrowers in the type of which			Percentage of individual type linkage to total linked households
		Irrigated Area	Non-Irrigated Area	Total	
Landless Labourers	Credit Labour	-	-	25	100.00
Small Farmers	Credit Input Output	16	4	20	40.82
Small Farmers	Credit Output	4	7	11	22.45
Marginal Farmers	Credit Labour	3	7	10	20.40
Small Farmers	Credit Tenancy	4	4	8	16.33
Total	-	27	22	49	100.0

Source: Sarap (1986)

**Table 4: Interlinked Credit Transactions: Farm Size and Tenancy Typewise (Sirkerhat and Choto Asulia: 1988-89)**

Name of the interlink transaction	Type of linkage	Small Farm				Middle Farm			
		Owner	Owner-Tenant	Tenant	Total	Owner	Owner-Tenant	Tenant	Total
<i>Village: Choto Asulia</i>									
Bandhaki/Daisudi	Credit-Land	1 (25.00)	3 (75.00)	-	4 (100)	-	-	-	-
Challani	Credit Land Tenure	-	-	-	-	-	-	-	-
Dadan	Credit Crop	8 (27.59)	7 (24.14)	14 (48.27)	29 (100)	-	4 (40.00)	6 (60.00)	10 (100)
Hawlia	Crop-Crop	-	-	6 (100)	6 (100)	-	-	-	-
<i>Village: Sirkerhat</i>									
Bandhaki/Daisudi	Credit-Land	2 (33.33)	4 (66.67)	-	6 (100)	-	-	-	-
Challani	Credit Land Tenure	-	-	2 (100)	2 (100)	-	2 (33.33)	4 (66.67)	6 (100)
Dadan	Credit Crop	3 (20.00)	4 (26.67)	8 (53.33)	15 (100)	-	4 (30.77)	9 (69.23)	13 (100)
Hawlia	Crop-Crop	-	-	4 (100)	4 (100)	-	-	1 (100)	1 (100)

Source: Banik (1993) and (1998)



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Thus, friends and relatives, traders and other professionals often offer credit in cash to farmers before harvest and receive certain quantities of paddy at the time of harvest under an arrangement called *dadān*. There are also cases where consumption loan is given in terms of quantity of grain valued at a certain specific price (mostly at the time of lean season). This in turn compels the farmers (mostly tenants) to repay a much larger quantity than the actual quantity borrowed since relatively lower prices prevail at harvest time. The arrangement is known as *hawliā*. It seems important to note a kind of labour contract which is very common in rural Bangladesh, as for example, *kamlachukti* in a village of Bangladesh. Under this system, the casual labourers take loan in the lean season and pays labour services for one crop season at the rate below market rate. The motivation for the loans is to ensure a dependable supply of labour where the timeliness of operations is becoming increasingly important.

Banik, *op. cit.*, reported that leasing contracts are not confined merely to land but also extended to other productive assets such as milch cow, bullock, sheep, goat, and fowl under an arrangement called *baga*. The bullock, goat or fowl is reared by the "lessee", his "crop share" being his share of the enhanced asset value of the animal or bird when it is sold. A sheep, milch cow, goat or fowl may be loaned in kind, the amount being repaid through an equal number of progeny with interest being share of the sale proceeds of milk or egg until the loan is repaid. In both cases, asset (like land) is transferred to the lessee and is either returned later (rearing) or replaced by progeny (to be lent again).

Turning to evidence in the context of Nepal, Shrestha and Conway (1985) observed that under an informal credit market structure, the mode of socioeconomic surplus appropriate by creditors from debtors takes several forms. For example, creditors charge exorbitantly high interest rates (which range from 35 percent to 65 percent in the case of Chitwan), obtain free labour services in some cases, or pay wages lower than the current market rates, or all three. Generally, creditors are also landlords who lease lands to tenants for cultivation; they charge high ground rents or garner large shares (at least 50 percent) of production, to which they contribute nothing other than the land, the supply of which they firmly control. In addition, market outlets for agricultural products are controlled by creditors in an indirect way (Table 5).

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**Table 5: Net Credit and Debt Structures in the Hills and Chitwan**

A: Hills								
			No. of Households	Percentage of subtotal (Households)	Amount in Rs.	Percentage of subtotal	Percentage of total sample population	Average amount
1	Collect (Creditors)	a	8	21	185.000	85		
		b	30	79	33.700	15		
	Subtotal		38	100	218.700	100	10	5.755
2	Payback (Debtors)		85	-	207.800	-	24	2.445
3	No. Financial dealings		241	-	-	-	66	-
	Total		364				100	
B: Chitwan								
1	Collect (Creditors)	a	7	25	174.000	85		
		b	21	75	29.000	15		
	Subtotal		28	100	203.900	100	8	7.290
2	Payback (Debtors)		191	-	478.200	-	52	2.505
3	No. Financial dealings		145	-	-	-	40	-
	Total		364				100	

Sources: Shrestha and Conway (1985)

The tenant-debtor is generally required to repay his debt right after the harvest is in. This means he is trapped in a regressive market mechanism in two ways. First, since he does not have any other means to repay his debt, he is forced to sell his produce following the harvest, most often to his creditor or to the creditor's agent, probably at a pre-arranged price. This means he most likely gets less than the current market price. Second, sale of crops immediately after the harvest means the tenant debtor probably receives as much as 25 percent less for his produce than what he could have obtained at a later point in time when the market prices normally go up.

#### 4. Conclusions

The study reveals that interlinkage is one of the most important mechanisms in South Asia. Informal credit markets are an important part of the rural financial system

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in this region. When the individual loans they deal in may be relatively small, in terms of total turnover these markets may equal or even exceed loans volume in the formal sector. For most small and poor borrowers, informal credit markets are likely to remain the only source of finance in the medium term. Through which the informal sector reduces its transaction costs and risk premia. Hence it is useful to address the promotion of links between the formal and the informal sector in the areas and segments where competitive conditions prevail, taking advantage of its lower transaction costs to "retail" credit. In effect, the approach is the co-opting of informal sector, without destroying its essential informality. This approach would also seek to strengthen and expand the existing linkages between the two sectors. In particular, it would encourage the use of agricultural input suppliers, e.g. fertilizer and pesticides dealers and output purchasers and commission agents (e.g. paddy traders, fruit and vegetable traders, rice millers) to take advantage of the interlinkage between credit and commodity transactions as a means of reducing transaction costs and risk premia.

Some countries have already experimented with scheme to use input and output dealers to on lend informally. This is usually not done openly, "supervised" credit programs lend only directly to the ultimate user of funds in an attempt to control their use, an attempt made somewhat difficult because of the fungibility of funds. However, if informal lenders can provide funds to small borrowers more cheaply, it may be desirable to enable them to do so openly, subject perhaps to the setting up of suitable mechanisms to monitor on lending rates and ensure that there is sufficient competition to prevent such lenders from taking advantage of access to cheaper institutional credit to make abnormal profits. There appears to be a good case for vigorous pilot project experimentation to test this approach.

Perhaps, cheap and plentiful institutional credit is not an entirely satisfactory solution to the problems of farm households with uncertain outlays and incomes (Adams and Nehman 1979). If private credit is dear and scarce, the first step is to establish why it is so; only then is sensible prescription possible (Bell 1988). There are several ways in which government can reduce the lender's cost of business; if market power keeps private credit dear, government can attempt to encourage entry. In both cases, indirect intervention might be best. For example, public investments in rural infrastructure and policies which promote agricultural output might reduce lender's cost and encourage entry far more powerfully and efficaciously than a volume or two of regulation. Thus, it is quite possible that well-functioning rural credit markets are a

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consequence rather than cause of general development. In any event, it should now be clear that the extension of highly regulated institutional banking services, which has been so vigorously prosecuted by the government, is not the sole means of realizing economic efficiency and distributive justice as far as dealings in credit markets are concerned.

Governments are unlikely to forsake this path entirely; nevertheless it is important that the associated policy be pursued in the right way. It is sometimes argued, for example, that the ills of regulated institutions can be cured by the simple expedient of raising the rate of interest on their loans, as if credit were a commodity like wheat or milk. The notion is that, since there is an excess demand for loans and views, accordingly it should be eliminated. Higher rates of interest might be beneficial for other reasons; for example in reducing the subsidies received by the well-connected, in permitting regulated institutions to pay higher rates on their deposits and in improving their credit. But as the rate of interest is not a sufficient condition for the price of funds, one should not expect too much of it. What is needed is more work on the nature and consequences of competition and attention to create an ideal precondition of competition (Von Pischke 1978).

Conventional banking practices do not work for the rural poor. The requirements of physical collateral and enormous amount of paperwork ignore the realities. Poor people cannot afford to risk their limited holdings of land or livestock, while illiteracy makes bureaucratic paperwork a daunting obstacle. Paperwork should be minimal, and 'social collateral' or any other common responsibility system must be used to determine the creditworthiness of the poor.

It is imperative to adopt a local approach. There is no single workable blueprint for providing financial services to the poorer sections in every location. However, technical support and training for the poor are preconditions for success. Regulations to protect savings and minimize loan defaults are necessary, but they should be flexible enough to recognize informal institutions and allow local organizations to set their own rules.

Rural finance alone will not be able to alleviate poverty, because more credit does not necessarily mean less poverty. Appropriate policies and good governance are critical for creating an environment in which financial services can make a positive difference to the poor. People must be sufficiently educated and healthy to make pro-

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ductive use of credit. Efficient, functioning markets too are critical to small-scale farmers and entrepreneurs in obtaining the inputs and output they need to produce and market their products.

On the basis of same rationale, small farms must not be a separate entity. Public and private investment can make other markets efficient. Tenurial Institutions like cash rent or cost-share agreements are few of them. Indeed with more pro poor institutions and policies, many more poor people could benefit. Thus, the problems have to be seen by the policy maker in an integrated way instead of compartmentalizing the issues.

A systematic investigation of the many relevant policy and operational issues is necessary to provide the factual and analytical support for an optimal policy and regulatory environment. Such an investigation might also show how informal credit markets, with all their strengths and weaknesses, can be utilized in the development process.

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## Abstract

*This paper examines the evolution of informal financial institutions in the farm sector in South Asia. The discussion is based on relevant literatures and author's field works in the region. The study reveals that interlinkage is one of the most important mechanisms in South Asia through which the informal sector reduces its transaction costs and risk premia. The findings may lead to regional specific solutions as there is no standard blueprint in this respect.*

