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IFPRI

#### RESEARCH PROGRAM MISSION

The research program titled Rural Financial Policies for Food Security of the Poor seeks to identify policies and institutional arrangements that help the poor integrate themselves into sustainable savings and credit systems in order to increase capacity to invest, bear risk, and preserve livelihoods.

#### FOCUS COUNTRIES

- Bangladesh
- Cameroon
- China
- Egypt
- Ghana
- Madagascar
- Malawi
- Nepal
- Pakistan

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# RURAL FINANCIAL POLICIES for FOOD SECURITY of the POOR

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## Informal Markets: What Lessons Can We Learn From Them?

MANOHAR SHARMA AND MANFRED ZELLER

In most developing countries, it is the private, informal markets that the rural poor have traditionally turned to service their financial needs. Why have these institutions succeeded in providing services to the poor when formal institutions have not? Do these informal institutions provide any lessons that bigger formal institutions could use? What are their basic limitations? Answers to such questions indicate important directions for public policy.

Typically, institutions can be categorized as follows:

1. **Lending and borrowing among relatives, neighbors, and friends.** Borrowing from socially close lenders is often the first recourse that poor households have in financing expenses, especially those related to essential consumption expenditure. Transactions are collateral-free and in most cases interest is not charged. These are essentially informal social insurance schemes that have the principle of reciprocity at the core of transactions. Hence, both the lender and the borrower gain from the transaction, and the process is self-sustaining. The borrower is able to finance urgently needed expenditures quickly and with little transactions costs: there is no lengthy appraisal process involved, little or no paperwork or travel time is involved, and the terms of transactions are well understood. The lender gains a right to reciprocity that he can lay claim to in the future. Further, risk of loan recovery is at a minimum since the lender only lends to persons who are part of his or her social network, within which contracts can be enforced. For each partner, therefore, the long-term gains associated with maintaining borrowing privilege is greater

than the short-term gain of renegeing on the payback.

2. **The rotating credit and saving associations (ROSCAs)** found in many countries are also network-based but address different needs of its members and the rules of conduct are more formalized. These associations, which may even operate under a designated manager, pool in savings from members each period and rotate the resulting pot among them using various rules. The process is repeated each period until the last member receives the pot. Because of the rotating rules, these schemes are less suited to address household risk unless the timing of the receipt coincides with unexpected events. Also, unlike demand deposits, once the saving is committed, it cannot be drawn immediately and the member is required to wait her turn.. The main goal of a ROSCA is to mobilize savings and channel this to borrowers in some prespecified order, and thus fulfill an important intermediation function.

3. **Informal moneylenders.** Typically, informal moneylenders are approached when the amount of credit required is larger than can be obtained from friends and neighbors. Moneylenders charge explicit interest rates in order to obtain real positive returns on their capital. In fact, interest rates are usually high and rates in the range of 5-7 percent per month are not uncommon. Typically, moneylenders lend only to households about whom they possesses enough information. However, they may also lend to others about whom they possess less information if punitive actions on those that default are feasible. In communities in which they are acceptable, lending may be either explicitly secured by collateral, or

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upon a community-wide understanding that allows the lender to resort to punitive action when contracts are breached. The informal nature of these transactions must be noted: these sanctions are enforced not by any legal authority but by the commonly understood rules of the communities themselves. Of course, this may not be feasible in all communities.

4. **Tied Credit.** Credit transactions are frequently tied with transactions in land and labor markets to circumvent problems of inadequate information and lack of collateral suitable assets. Thus, traders disburse credit to farmers in exchange for the right to market the growing crop; shopkeepers increase sales by providing credit for food, farm inputs, and household necessities; large landholders secure access to labor in the peak season in return for earlier loan advances to laborers. The important feature of these types of transactions is that the lender also deals with the borrower in a nonlending capacity and is able to use this position to screen applicants and enforce contracts.

### Lessons From the Informal Sector

A number of important lessons can be learned from the informal systems described above.

1. **Credible long-term partnership.** The belief that the accumulated benefits associated with continued long-term transactions are larger than short-term gains associated with delinquent behavior is what propels self-enforceability of most informal institutions. Formal institutions therefore also need to successfully demonstrate to clients in small rural communities that they are not transitory phenomena and that it is worthwhile for them to invest in a long-term, profitable relationship. This demonstration is essential for maintaining high repayment rates. Short-term and sporadically implemented "credit projects" generally encounter higher rates of loan delinquency precisely because short-run gains associated with default outweigh extremely uncertain future gains.

2. **Tailoring financial services to specific demand patterns.** As with the marketing of any products, financial services need to be finely sculpted to specific demand patterns of the borrowers. For the poor, borrowing privilege in various informal institutions is worth preserving precisely because their services are very responsive to specific conditions of households. Emergency loans, for example, are obtainable immediately on demand, repayment structure is closely linked to local production cycles associ-

ated with the borrower's occupation, and loans are renegotiated, taking into account both lender's and borrower's specific circumstances. These attributes greatly increase the utility of loans to borrowers and provide further incentive for them to retain borrowing privileges. On the contrary, when loans terms are incompatible with local production patterns or when loans are tied to activities that, given the structure of local resources, yield poor returns, very little is gained by retaining borrowing privileges. Benefits from defaulting in such cases may outweigh retaining borrowing privileges.

3. **Knowledge of local economy is important; therefore, so is decentralization of decision-making.** The ways in which financial transactions are interlinked with transactions in the market for land, produce, and labor by informal agents indicate the potential for making such types of innovations in the formal sector. This requires intimate knowledge of the structure of local economy as well as of local institutional arrangements that may be used to strengthen financial links between the borrower and the lender. Generally this is not possible within a top-down organizational framework; what is needed is the active involvement of front-line managers who can design financial products that take full account of local institutions and local resource endowments.

4. **Not all financial contracts are self-enforcing and adequate steps must be taken to enforce contract compliance.** The majority of informal financial contracts between friends and relatives are of a self-enforcing nature, but socially distant lenders depend a lot on external, though not necessarily legally codified, mechanisms to enforce repayments. Just as moneylenders win the mandate of small communities to take punitive actions against defaulters, it is also important for formal institutions to have clear and implementable plans for contract enforcement and loan recovery before lending begins. Lack of a credible plan will only invite greater rates of default. ■

### Selected Reference

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### ABOUT IFPRI

IFPRI's mission is to identify and analyze strategies for meeting food needs of the developing world, with particular emphasis on low-income countries and the poor.

IFPRI is a member of the Consultative Group on International Agricultural Research (CGIAR).

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