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TRIP REPORT
PRELIMINARY IFM STUDY TRIP TO BANGLADESH

By

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Background

Informal financial markets provide the bulk of finance in many developing countries and display remarkable resilience and efficiency in savings mobilization and credit allocation. On the other hand, they are alleged to have significant shortcomings in comparison to formal financial markets centered on government regulated and monitored institutions. Policymakers have displayed a rising interest in these markets on a variety of grounds:

- To understand their functioning and how they react to monetary, fiscal, and credit interventions on the part of the government.
- To combat their baneful influences with corrective interventions.
- To mimic their merits in formal financial institutions.
- To use them as vehicles for intervention and promotion.

These possibilities are particularly attractive because of the degeneration of formal financial institutions in a number of developing countries and their manifest inability to serve the needs of small producers and traders.

Interest in informal markets has been around for some time. They were a subject of great interest to the Indian Banking Commissions of 1931 and 1971, which made recommendations for their integration with the formal sector -- none of which were ever implemented. I participated in a study of these institutions in India in the late 1970s sponsored by the World Bank. Roughly at the same period, the same section of the Bank sponsored studies of the informal sector in Korea (where, along with Taiwan, there exists an extensive literature). More recently, the TDRI and the Bank of Thailand have sponsored extensive studies of them in Thailand. The individual country literature is quite extensive. The "Ohio State School" of scholars of agricultural credit have paid particular attention to these markets, as have more generally those who study the results of financial repression -- the attempts to suppress financial markets and instruments by law. (Fry, Diaj-Alejandro, etc.)

More recently, the OECD has sponsored a series of studies of these markets in Africa, and the ADB, a series in the countries of India, Bangladesh, Thailand, Philippines, and Indonesia designed to get data to address some of the policy issues raised. USAID in Bangladesh agreed to support this ADB study in Bangladesh, where USAID has extensive involvement with banking and credit issues and plans for more extensive programs. These involvements were instanced by the Rural Finance Experimental Project and the Rural Finance Projects, under which extensive studies were conducted of numerous aspects of formal financial institution functioning, and to a certain extent, of informal financial systems as well. After some discussion, it was agreed that USAID would underwrite the study of "urban" markets and ADB of "rural" markets, but that they would coordinate their studies and run them both through the Bangladesh Institute of Development Studies, the premier research institute in the country, and under the general direction of Dr. Atiq Rahman of that institute. Dr. Rahman is a well known scholar who has done extensive work on financial and other economic issues. It was agreed that two senior scholars of Bangladesh would also be connected as advisors with the study -- Dr. Muzaffar Ahmad, the former head of the Institute of Business Administration of Dhaka University, for the "urban" side, and Dr. Akhlaqur Rahman of the Economics Department of Jehangirnagar University for the "rural" side. Dr. Thomas Timberg, Director of the ARIES Project (Assistance to Resource Institutions for Enterprise Support) of Robert R. Nathan Associates, Inc. in Washington, D.C. was commissioned by USAID/Dhaka to serve as an advisor on its part to the Project, and released by USAID/Washington, to advise the ADB in its overall work. The ADB project is being run out of its Economics Office by Dr. Prabhu Ghate, a Princeton Ph.D. and Indian civil servant seconded to the Bank, who has written widely on rural development issues, including targeted rural credit programs.

A conference was held at the end of May 1986 in Manila at the ADB at which the different country teams presented the state of knowledge about informal credit markets in their own countries and their plans for further study. In general, due to limited funds, the strategy was to do focussed case studies on strategic sub-markets -- from which it was hoped data would emerge to address the subjects noted for consideration during the Project.

In the final report, it was agreed that 19 points would be covered which deal with the entire range of subjects of interest to policymakers concerning financial markets.

"Terms of Reference as Approved by Workshop"
(This a verbatim copy through page 7)

The country studies are envisaged as a series of topics, belonging to four broad sections. The first of these will be primarily descriptive and will aim at establishing the structure and size of, and trends in, informal credit markets. The second section will deal with the role and performance of the informal sector in relation to the policy concerns referred to below. The third section will analyze interest rate formation and market structure in the informal credit sector as the underpinning for investigating the feasibility and design of the operational approaches described in Terms of References 15 and 18. The concluding section will attempt to identify an optimal policy environment on the basis of the findings and analysis of the study. The topics are discussed further in the Background Paper and some suggestions on their treatment contained in the Report of the Design Workshop.

Section I

1. Estimating the size of the informal sector, both rural and urban.

2. Trends in size, and factors contributing to the growth or contraction of the informal sector in the short and long term (such as financial "repression" or liberalization in the formal sector, growth of the volume of formal sector credit, growth of urban informal enterprises, growth in the demand for consumption credit, remittances from workers abroad received through non-banking channels, etc.).

3. Establishing the major structure of the informal sector; its segmentation and sub-markets, each with its own size, sources and uses of funds, market participants, interest rates, documentary instruments, linkages with each other, and with the formal sector. In particular, a classification of markets into homogenous borrower groups/borrowing purposes with a view to assessing the existing role and potential contribution of the informal sector in meeting them.

4. The policy and legal environment (usury laws, debt moratoria, registration requirements, restrictions on deposit taking, etc.).

Section II

5. The savings mobilization role of informal credit markets. An analysis of the sources and uses of funds to assess the net additive contribution of ICMs (Informal Credit Markets) to savings, by offering savers a higher return, possibly, than formal sector institutions. The role of Roscas (known as paluwagan in the Philippines, arisan in Indonesia, pai-hueys and "chaer" games in Thailand, and chit funds in India) in mobilizing household savings in particular. The impact on the saving mobilization role of the informal sector on restrictions placed on deposit taking on NBFIs (Non-Bank Financial Intermediaries) and other informal intermediaries.

6. The role of informal credit in meeting consumption needs.

7. The impact of informal sector credit on allocative efficiency.

8. The equity impact of ICMs in making credit available to small borrowers (e.g., the small enterprise sector, marginal farmers, women entrepreneurs, etc.).

9. The efficacy of monetary policy, credit policy, and selective credit controls in the presence of an informal sector.

10. Interaction between formal and informal credit and the extent to which they are substitutes or complementary.

11. Channels of linkage between formal and informal sectors (e.g., trade credit, access by informal lenders to the banks).

12. The informal sector and depositor security. The incidence of fraud and "failures" as compared to that in the formal sector.

Section III

13. Interest rate formation in the informal sector. The relative importance of (i) transactions costs, (ii) risk premia, (iii) cost of funds, and (iv) monopolistic (or obligopolistic) profits stemming from market power.

14. Trends in interest rates. How they compare with formal sector rates when "hidden" costs and borrower transactions costs in both sectors are included. The relationship between interest rates, collateral, the purpose, size, and duration of loans, and borrower and lender type.

15. Where monopoly profits exist, the feasibility and design of policy action to engender more competitive conditions (e.g., through more effective competition from the formal sector, changes in the legal environment, encouraging new informal entrants through refinancing facilities, etc.).

16. A documenting of the advantages of informal credit as a source of possible innovations in the formal sector.

17. Regarding transactions costs and risk premia, the behavioral characteristics, practices, and mechanisms through which informational links are formed and maintained with borrowers, and debt service ensured, with their advantages and disadvantages. In particular, the importance of interlinkage of transactions in credit with those in land-lease, labor, and product markets. The extent to which interlinkage is taking different forms (e.g., the increasing importance of input-dealers and output traders with land reform and the commercialization of agriculture). Is the dearth of, and control over, credit used to obtain more favorable terms in other markets, or is the existence of contracts in other markets an enabling condition for credit

transactions too, serving to increase the availability of credit and perhaps even lowering its costs?

18. Where competitive conditions exist, but the opportunity cost of funds is high, the feasibility and design of refinancing schemes to reduce the cost of funds and take advantage of the lower transactions costs of informal lenders (whether on accounting interlinkage or otherwise) by using them as retailers of credit.

Section IV

19. An optimal legal and policy environment towards the informal sector.

It was agreed that the Bangladeshi studies would attempt to answer the questions in the overall terms of reference and largely be based on case studies of the financing arrangements for specific subsectors like handloom weaving or gold trading, though a small survey would be conducted on the rural side. Terms of reference and contracts were worked out between BIDS and USAID and ADB.

The USAID contract, signed September 15, 1986, incorporated a Terms of Reference which roughly covered the 19 points and used the methodology of the overall project. A variety of methodologies were suggested, though it was emphasized that borrowers and well as lenders need to be covered. It was agreed that networking and selected interviewing rather than survey research techniques were appropriate "anthropological" techniques, as some participants phrased it.

This terms of reference is further amplified in the Work Plan submitted October 1, 1986 discussed by the Project Steering Committee and approved by AID/Dhaka as the first condition precedent for the release of AID funds.

Under this Work Plan, information will be sought on a variety of items to be covered in each case study.

<u>Contents of Case Studies</u>
<u>(Slightly edited quote)</u>

In broader terms, the work in each of the prescribed case studies would include:

i) estimating the size and identifying the factors contributing to the growth of that particular segment of IFM (Informal Financial Markets), i.e., the segment supporting the particular activity. The term "financial" is preferred by AID to "credit" to emphasize the role of those markets both on the savings and credit side

ii) describing the structure of IFM for that activity with details on the nature of transactions, costs of transactions (risk premia, monopoly profit, costs of fund, etc.), variation in interest rates, inter-linkages, etc.

iii) analyzing the role of the market segment in mobilizing savings

iv) analyzing the interaction between monetary policy and factors affecting the IFM segment and examining the effectiveness of monetary instruments, and

v) providing recommendations about making the market more competitive, efficient, and equitable.

Specifically, the case studies should seek to assemble information on the following aspects of informal credit operations with respect to each economic activity in which these credits are used:

1. <u>Market Segmentation</u>: Informal credit markets are alleged to be segmented along by various patronages and lineages, local political groupings, trading, and production. One particular case study cannot reveal the extent of segmentation for the whole ICM;

but it should be able to provide information on segmentation within one particular activity line.

2. Identification of Lenders: Identification of the categories of lenders. It should go beyond categorizing the lenders as "friends and relatives," "well-to-do people," "professional moneylenders," "traders and shopkeepers," etc. Our suggested approach of participatory research should be best suited in tracing the real actors instead of categorization on above line.

3. Categories of Borrowers: Since the case studies will follow specific activity lines, identification of borrowers will be almost pre-determined. Even then case studies may contradict our a priori expectations. There may well be a situation in which different categories of borrowers exist depending on the nature of ownership of the enterprise in question.

4. Nature of Relationship: One important task is to explore the nature of relationship between the lenders and borrowers. Here again, the suggested method of study will be particularly suitable for revealing many unquantifiable variables that may prevail when interactions take place between lenders and borrowers...non-credit "power" feudal relations, for example.

5. Nature of Credit Operation: ...For example, the prevailing level of sophistication or degree of organization in credit operation needs to be known. It seems to us that unlike India and other countries of the region, ICM operation in Bangladesh is "informal" in its real sense.

6. Sources of Funds: The case studies should not limit their research to immediate sources of the ICM funds, but attempt to trace the ultimate sources from which the ... money flows. Whether these credits originate from lenders' own savings, relations' foreign remittances, or other variations of transfer of funds (including black money) need to be known to analyze the DRM (domestic resource mobilization) implication of ICM operation. Similarly, attempts should be made to find out whether the ... money originates from increased money supply, increased money circulation, increased use of a given volume of savings, etc. Although an

independent attempt is planned to examine the nature of interaction between the formal and informal financial markets, case studies should endeavor to collect as much information as possible on inter-linkages between the two sectors and the interface between the rural and urban informal financial transactions and the mechanism of such transactions.

Attempts should also be made to trace any sign of funds flowing out of particular activity to another (may be from low productivity to high productivity uses or from obsolete activity to modern/new activity.

7. Uses of Funds: Specific purposes for which the informal credit is used in the urban areas need to be identified for evaluating ICM's role in the development process. ... such information will facilitate delineation of the specific area of credit use for purposes of (i) raw materials, (ii) trade goods, (iii) capital equipment and for meeting the needs for working capital. Since credits are fungible, it is important to know their uses at the margin. Again, the case study approach should be useful in this regard, if not in quantitative terms, at least in revealing the qualitative dimensions.

8. Collaterals in ICM: It is generally believed that collateral needs and demands of ICM operation are either nil or minimal. But it may be ... that instead of tangible collateral in terms of asset security, personal ... demands relations (such as long acquaintance, trust, relationship, etc.) serve the purpose of collateral. Case studies should be able to reveal this aspect with all its dimensions.

9. Level and Structure of Interest Charges: A major concern regarding ... informal credit is the high rate of interest charged by the lenders. In cases where lending involves non-monetary terms of interest ..., the level of interest rates may be even higher. It is not enough to reveal the particular level or range of interest rates that prevail in the ICMs; what is more important is to know how much the prevailing rates of interest result from monopoly or reflect competition among borrowers, how much is accounted for by transaction costs, and how much by pure interest rates or risk factors. The level and structure of interest charges in ICMs should be studied in association with (a) collateral needs,

(b) time span of credit, (c) repayment schedule and terms, (d) interest rates charged by FFIs (Formal Financial Institutions), etc.

10. Trends: ... to know what has been happening over time on various aspects of ICMs in Bangladesh. Unfortunately, this is the area where the least is known and even the proposed case studies are unlikely to satisfy us. But rapid changes have been occurring in the urban economy of Bangladesh. At least two historical events have shaped these changes: (i) situation arising out of partition of the Indian subcontinent and consequent migration of traditional moneylenders, and (ii) emergence of Bangladesh as an independent nation and Dhaka as a national capital and metropolis (leading to growth of a variety of new economic activities).

In the absence of information on the operation of ICMs at different time points, the possibility of tracking their trend is limited. Yet serious attempts need to be made in the case studies to fill up this gap as far as possible by assembling historical data on various changes through appropriate queries to the respondents.

11. Broad Macro Issues: Some macro issues, especially ... those having implications for government money and credit policies, were noted previously. There are certain other macroeconomic issues which will also have to be dealt with in the final output of this study. For example, it is expected that the study will shed some light on the growth and equity implications of ICM operations. To ... devise government policy towards ICM operations, it is also important to know that availability of informal credit does not merely facilitate higher ... private return at the cost of lower social benefit. Case studies, in isolation, cannot satisfactorily address ... such questions. But any information pertaining to those issues will be extremely useful for the final output of this project.

Types of information expected from the case studies have been noted above in some detail. In addition, each activity line is expected to generate activity-specific data on ICM operation. For example, the case study on the role of ICM in textiles products will especially look into the putting-out credit systems, i.e., in handloom production in which yarn

> is provided by merchants and in dyeing and printing in which raw cloth may be provided by merchants. Similarly, in wholesale trading, credit in kind may play an important part. ... In the case of metal products, ICM is likely to have interlinkage with FFIs for purchasing capital equipment and collection of discarded metal items from ship-breaking businesses. The case study on gold merchants, an activity traditionally connected with lending and finance, is likely to generate some very atypical information on ICM operation. (End of Quote)

The five broader and 11 specific points of the terms of reference for the contents of cases roughly correspond to the 19 points of the overall ADB program. Some of the points are not as fully covered in the AID terms of reference as in ADB's because they will presumably be covered with ADB funding, especially the question of the monopoly and risk elements in IFM charges, the legal and policy context, and IFM impact on consumption needs and resource allocation.

Report of What Has Been Done

Progress so far on the urban section of the study has relatively closely followed the schedule laid down in the Work Plan, with the exception of a one-week delay caused by the serious illness of Dr. Atiq Rahman. General terms of reference were prepared for an initial four case studies to be commissioned from various researchers in and outside of BIDS, and revisions proposed in these case study terms of reference.

Some of these general terms for these case studies were outlined in the terms of reference:

Terms of Reference (TOR)
(Verbatim Quote)

The terms of reference of case studies, inter alia, should be specific to the following areas. The questions framed in studying the activity should be directed to gather detailed information on the TOR.

(a) Identification of inputs and outputs of the productive activity

(b) Putting out credit system for inputs and outputs

(c) Assessment of working capital requirement

(d) Identification of sources of credit and their terms conditions

(e) Establishment of historical background and role of informal credit sources

(f) Establishment of linkages between different sources, if any

(g) Estimation of interest rate and its composition

(h) Impact on informal credit interest of offering effective competition from alternative sources

(i) Assessment of informal credit market size

(j) Identification of factors which contribute to growth of informal credit market

(k) Information on formal and informal sector interlinkage

(l) Estimation of the resource base of the lenders and borrowers

(m) Estimation of needs and ways of supplying the credit. (End Quote)

Methodology: Sources and Uses of Funds

The basic method used will be to get some sense of the sources and uses of funds by different participants in the economic activity study. This will have to be secured by careful interviewing and cross checking with a variety of market participants.

Case Subject

The first four studies will include two on the financing of the handloom industry, one on the financing of small engineering workshops in the Dhaka area, and one on the bullion and jewelry trade. One of the handloom studies will be centered in the concentration around Shahzadhpur and Serajganj in Pabna and the second around Narsinghdi in old Dhaka district. Initial interviews were conducted with prospective investigators and knowledgeable informants. What remains is for contracts with specific terms of reference to be signed as soon as possible.

Among those interviewed were several temporary BIDS staff who have just finished working with the SRID project'[1] particularly Faruq Akhtar Choudhury, Naushadh Faiz, and Riaz-ul-Islam. All of these appear to e highly qualified. Faruq Choudhury has been suggested as Principal Investigator to replace Nurul Amin of Jehangirnagar, who is still busy with a previous assignment. It is hoped that Amin will be free to participate in the second round of case studies. I have worked with Mr. Choudhury in the field and have been impressed with his ability to rapidly comprehend and analyze field data

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1. The SRID studies in Rural Industrial Development Project was funded by the World Bank, to some extent, as a follow-on to several surveys of the small-scale enterprise sector. It was designed to identify the specific possibilities and resources for new small enterprise creation in certain selected thanas. The programs developed included specification of entrepreneurs, funding sources, and technology.

and acute sense of Bangladeshi economic reality. He has done graduate work at the University of Waterloo in Canada and has been responsible for the completion and editing of the 40-odd thana studies under the SRID project. Both Dr. Faiz and Riaz-ul-Islam are impressive and highly qualified scholars. Dr. Faiz is unusual in having a doctorate from Moscow State University, Russia's most competitive, to which relatively few Third World candidates are admitted, as well as having done graduate work at the University of Michigan. He is himself actively involved in business. Mr. Riaz-ul-Islam has a degree from Strathclyde University in Glasgow -- an institution with particular interests in technology choice. We also interviewed Dr. Syed Siddique, a rural sociology Ph.D. from Cornell, who teaches at Rajshahi University and has just had an article on rural credit markets focussed on the Gramin Bank published in Development and Credit. MIDAS, a Bangladeshi consulting and enterprise promotion institution, also indicated some interest in doing a case study, and they certainly have the proper background if they can release the manpower for such studies.

The studies are intended to take three months and be finished by March 1987. Since many of the intended contractors will not be able to begin until January, there is some possibility of slight slippage from the work plan. A second group of cases are intended to be contracted for in late December and completed between January and April. The second group of cases have not been finally identified, but may include studies on the financing of major wholesale commodity markets, trucking, employee savings schemes, leather working, and tanning. The last activity received particular support from USAID Program Officer Robert Kramer because of its potential export implications.

The ADB-sponsored activity in the rural sector will start somewhat later than originally planned because of a mail mix-up which meant that BIDS only signed the contract in early November. Because of the press of work in connection with the "urban" section of the project, Dr. Atiq Rahman did not anticipate he would get to work on it seriously until mid-December. This section, too, is centered on a series of 6-8 case studies, tentatively of activities financing the fertilizer trade, the trade in small-scale irrigation equipment, the trade in indigenous sugar, and country boats. The case studies are to be supplemented by a small survey of about 200 households in four villages conducted by the BIDS survey organization.

The number of case studies involved in both parts of the project means that Dr. Rahman will be hard pressed to recruit the number of qualified researchers required -- and we hope that neither the quality nor the research schedule will suffer. But I hope everyone agrees that if a choice is present, the schedule will have to give way to the demands of quality.

The project has made some tentative beginnings in scouting out informants in the first markets selected for study. Participants met with the officers of the handloom industry association which represents the handloom factories (those with 10-plus looms, whose 18,000 members almost certainly account for half the units in the country), and Mr. Alam Miya of MIDAS, whose voluminous reports on the industry contain endless data. It appears that most weaving is done on seven-day credit from yarn dealers in the major cloth markets who extend such credit on a 10 percent discount and insist on cash payment on the following market day. They, in turn, presumably benefit from various sorts of credit arrangements going back up to the major yarn merchants centered in Narayanganj who either import the yarn or purchase it from the mills.

Project participants met similarly with the bullion dealers and jewelry store owners associations and reviewed the MIDAS study of this industry. It appears that 50 percent of the inventory of the typical jewelry store represents advances from one particular bullion dealer with which it is linked.

The difficulties with gaining the cooperation of the bullion dealers were great enough so Dr. Rahman raised the possibility that that case study might have to be abandoned.

Project participants gathered secondary material on the small engineering workshops, of which there is a fair amount (but unfortunately could not find the records of the extensive research USAID had done in connection with a proposed discount facility of its own for these shops), and interviewed a number of store owners in the Tipu Sultan Road, Dhulai Khal area of Dhaka. Appointments were made to meet with the appropriate trade association. A variety of financing arrangements exist -- including pure moneylenders, rotating credit arrangements, and credit extended by brokers and metal dealers.

In each case, we have a trading chain in which certain surplus units fund others -- the key question will be to determine the external sources of funds, if any, of those surplus units. They could be trading entirely on their own extensive funds, but this would, a priori, defy a basic principle of personal portfolio management that one wishes to distribute risks over a variety of instruments.

Alternatively, funds might come from public deposits, from formal sector bank credit (this particularly likely for importers who may be financed against their letters of credit), or from funds of those involved in the illegal remittance business. Our task will be to determine the costs of those funds.

At the risk of slipping into anecdotage, I should add a story my father-in-law told us recently about his father's business. His father dealt in used burlap and jute sacks. Each morning, he would stake peddlars who went around with horse carts gathering used sacks from bakeries (flour), construction sites (cement), grocery stores, etc. These would be delivered to him after noon, processed, bailed, and resold. The volume eventually was such that he developed trades in cement, flour, etc. The daily stakes to peddlars of $50 or so meant continued capital hunger, and my father-in-law remembers his mother had the job of getting demand money from such cash rich local businesses as the ice cream stores.

My own role has been as a commentator and in providing some initial contacts and in starting the process. I joined in the various interviews of staff and informants and discussions on the approach. I should keep in touch by phone, pouch, and telex. I am planning a call mid-December. Later, my role should shift to assisting in analyzing the data and applying it to the general terms of reference.

The next report will thus deal more fully with the findings of the study.

What is To Be Done

So far, Dr. Atiq Rahman has been doing precisely what should be done to launch this study, and USAID's priority should be to assist him in that effort. The first tranche of funding and four signed contracts for the first four studies should be signed and the terms of reference agreed to as soon as possible. I hope someone will cable me via Ross Bigelow (S&T/RD/EED) as soon as this is done. The key details are likely to be the names of the contractors and subcontractors and the dates on which they will start work. I will call Dr. Atiq Rahman sometime towards the middle of December to check on the progress of the studies.

One key task will be the orientation of those who are to do the studies -- a matter to which Dr. Rahman has devoted considerable attention. The completion of these studies requires an unusual combination of abilities:

1. "Street smarts" to locate and establish rapport with IFM participants
2. Analytic ability to conceptualize and analyze the markets in economic and social terms
3. Enough literacy and self-discipline to write all this up comprehensively.

The next priority will be to commission the remaining 6-8 "urban" and 6-8 "rural" studies. This task, as I noted earlier, will not be trivial because of the shortage of qualified people available on short notice.

I have already talked with some people from the Economics Faculty of Dhaka University, but IBA, other universities, and freelance businessmen and journalists may be other sources. A lot of economic journalism appears in the Bengali weeklies -- especially Robvar and Bichitra -- and the journalists might be a source for conducting studies.

I had planned to return about February 17, 1987 to spend another three weeks reviewing the state of the various studies and perhaps being of some assistance in forwarding the studies underway. I doubt if even draft reports will be available before I leave, but we should have some idea of what they should look like. The RRNA office in Dhaka can "DHL" the drafts to me for comment when they are ready in March-May.

The ensuing period will be one of analysis and work on using the case and survey data to respond to the 19 points in the terms of reference. I should perhaps return for a wrap-up and analytic session in December 1987 or January 1988.

Appendix I

ECONOMICS OFFICE

ASIAN DEVELOPMENT BANK

REPORT ON THE DESIGN WORKSHOP FOR A REGIONAL STUDY OF INFORMAL CREDIT MARKETS

May 28-30, 1986

MANILA

PHILIPPINES

August 1986

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This is a brief report on a workshop held to finalize the design of a comparative study on informal credit markets in Bangladesh, India, Indonesia, Philippines and Thailand. The studies will be carried out by research institutes in the countries concerned, in furtherance of the Bank's objective of promoting research collaboration in the region.

The workshop was held in Manila on May 28 to 30, 1986. The terms of reference for the study and a list of participating researchers, resource persons, and observers is appended. Copies of papers presented at the workshop and Vice-President Narasimham's opening address are available to interested readers on request.

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Economics Office

Asian Development Bank

August 1986

General Discussion

Describing the purpose of the workshop, P.B. Ghate, coordinating the project for Economics Office, explained that the terms of reference (TOR) for the country studies, at Appendix 1 of the Background Paper, were still indicative, and were for the workshop to firm up and prioritize, keeping in view the budget constraint. Clearly not all the topics were equally salient for all the countries, although hopefully a core set of topics would be identified for investigation by all the studies. He suggested that the first round of comments be restricted to general observations on the TOR and invited the authors of the country papers to make any further observations they might wish to. The following account does not describe what each participant said in the ensuing discussion, but merely highlights a few observations not covered in the country or background papers.

Several participants touched upon the dichotomy between an interest primarily in the structure of ICMs, the relationship between their various parts, how competitive they are, the efficiency of the arrangements they constitute for the inter-temporal transfer of resources, etc., on the one hand, and on the other hand an interest in ICMs primarily for instrumental reasons, viewing them as a means of promoting agriculture, small industries, etc., or, at a more macro level, savings, efficient resource allocation, price stability, and so on.

Several participants including two connected with Central Banks, emphasized the latter set of issues (e.g. the contribution of

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ICMs to considerable savings in many developing countries despite negative real interest rates in the formal sector). Other participants emphasized the importance of the former set of issues. However, it was clarified during discussion that although the interests of the country teams and the emphases of their studies would vary, there was no real conflict between the two approaches and indeed the TOR encompassed both (the first section, items 1 to 4, as well as 13) being primarily descriptive and "structural" in the above sense, the second section (items 5 to 12) macro-policy related, and the third section, micro-policy and "operations" related.

Two definitional issues that came up for discussion were the question of inclusion of trade credit (which it was decided the country studies should cover, since it formed one of the main inter-linking flows between the formal and informal sectors and was also important in quantitative terms), and the different levels of legality of ICMs. On the second issue the concensus was best expressed by Dr. Timberg: "We should perhaps define five thresholds of illegality. In most cases, the markets and institutions are not sanctioned or regulated by law. In many cases, their instrument and obligations are legally unenforceable. In some of these again, the contracting of private loans, but almost never the extension of trade credit, is a punishable offense. In all of the above cases the lender has legal right to his money, and the borrower to conduct the acitivity in which he is engaged. Finally we have black money markets proper where the lender has illegally obtained his money, not paying income tax on it, or not turning in foreign exchange to the authorities, and this money sometimes finances totally illegal activities like smuggling, or trade in forbidden substances.

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These levels of illegality have very different implications in their relation to productive economic activity. The last would be presumed to have no such relation. I would imagine that we are almost certainly interested in the first two levels of illegality, probably the third, and possibly the fourth."

One participant drew attention to the relevance of studying the experience of Japan, and how ICMs, which were important there until relatively recently, were absorbed into an integrated financial system.

On methodology, several participants emphasized the importance of devoting due attention to lenders (and not just borrowers) in the surveys, especially to get good information on transactions costs and the other elements of interest rates. Experience was exchanged on qualitative research techniques. It was observed that none of the country papers had proposed action research (although Mr. Holtz invited participants to contact him for information about the possibilities of funding that might be available as part of UN sponsored activities in this area). However, as an alternative, at least one of the country studies was proposing to investigate the effects of interventions that had been made in the past (e.g. the expansion and decline of formal sector lending) through what was termed by one of the resource persons as "historical research." Specific instance of similar interventions in other countries (e.g. the Banking Laws Amendment Act of 1982 in India) were mentioned for possible consideration.

Section 1 of the TOR (relating to the size, trends in size, structure, and policy and legal environment of ICMs)

There was a lengthy discussion on the usefulness, feasibility, and possible approaches to the task of estimating the size of ICMs. In the rural areas particularly, there was considerable seasonality in flows, with net borrowers even becoming net lenders and vice versa (as with farmers and traders). Thus charting the flows was as important as estimating the stock of outstanding credit at any given time. A problem with measuring flows was that the duration of loans varied considerably from a few days to a few years (although informal loans were predominantly short term). The concept of a baht-month (or peso-month) was suggested as a means of standardizing for this variation. However, even with these adjustments, at least one participant felt that an estimate of the absolute size of the rural informal sector was not likely to be very meaningful. Much more useful would be more disaggregated findings of the type: "farmers borrow 70% of their working capital from moneylenders".

While there was much sympathy for this view, most participants felt that it would be desirable to form at least a broad estimate of informal credit for those countries and sectors where such estimates did not already exist, and to refine existing estimates wherever possible, without putting a disproportionate part of the research effort into this task. It was pointed out for instance that in the Philippines it was not known whether informal credit constituted 90% or 10% of urban credit, levels which had very different policy implications in each case. Since the country studies would be studying the structure and

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segmentation of ICMs under TOR 3, and forming estimates of the absolute and relative size of these segments, it may be possible to arrive at overall estimates through a process of aggregation. Regarding trends in size it was generally agreed that attempts to establish these would have to be more qualitative, given the scarcity of time series data.

TOR 3 was generally felt to be crucial to the study and there was a lengthy discussion of the possible criteria to be used in identifying segments or sub-markets. It was suggested that in addition to lender and borrower identity and characteristics, instruments used in transactions be also considered as a basis for a better understanding of segmentation, especially as interest rates often vary by instrument between the same borrower and lender, and new sub-markets in ICMs sometimes emerge based on new instruments introduced in FCMs (as with the personal check market in Korea). A third basis was the functional purpose of the credit (e.g. the particular industrial and commercial activity it was destined for, fixed or working capital, consumption, and so on).

While interest rate differences were a useful first indicator of segmentation, markets with the same rates could be segmented geographically, or even within the same village based on information ties betwen lender and borrower. The various criteria were of course cross cutting, and it was for the country studies to identify the most appropriate combination of variables identifying the major segments. However, an overall picture of the structure of the informal market should be attempted, with estimates of the shares of the various segments, an assessment of the major sources and uses of fund within

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each segment, and flows between them and with the formal sector, as the basis for analyzing some of the macro policy related questions in Section 2 of the TOR. Regarding lender identity, the point was made by several speakers that given the overlapping nature of the classification commonly used, great care will have to be taken to infer the appropriate category from questions regarding the interest rate, the existence of interlinked transactions etc., rather than relying on the nominal status (e.g. "relative," "neighbor," etc.) of the lender.

Section 2 of the TOR (savings, consumption credit, allocative efficiency, equity, interaction the formal sectors and implications for monetary policy, and depositor security)

There was a lengthy discussion on the savings mobilization role of the ICM. It was pointed out that particular attention will have to be paid in this context to informal lenders and entities (such as Roscas), that function as intermediaries, although the Thai country team pointed out that they were struck, in their work on rural lenders so far, by the extent to which such lenders relied on their own equity, of which they had "excess capacity", so to speak.

Another distinction that emerged was between promoting savings and promoting the financialization of savings and it was possible that ICMs played the latter role as well as the former. There was also considerable discussion of whether funds mobilized by the informal sector that eventually financed consumption could be regarded as savings. It was pointed out that while funds mobilized by the informal sector could be regarded as constituting a net addition to savings in the national income accounts sense only if they resulted in a net increment to investment ex post, they do constitute savings in the sense of a deferral of current consumption, even if some of these savings are utilized as consumption credit. It was agreed that the studies would attempt to assess the savings mobilization role of ICMs in both these senses.

Regarding deposit taking one participant pointed out that some otherwise formal institutions (e.g. registered companies) accepted deposits although they were not legally authorized to. Such entities should also fall under the rubric of informal in this context, as should also credit unions organized by private voluntary organizations which function under self-imposed regulations. The main criteria in each case should be informality and flexibility. On Roscas, two motivation for participation were stressed; the compulsory savings element, and the need for people with relatively regular streams of income to provide for fluctuating cash outflows (a medical emergency, a business opportunity to be seized immediately, etc.).

On consumption credit it was pointed out that while informal credit performs fairly efficiently in Thailand in meeting seasonal credit requirements within a normal year, it is not so good at meeting requirements arising out of crop failures which necessitate the evening out of consumption between crop years. Neither formal nor informal credit meet this need.

On the question of allocative efficiency, some participants felt that the way the relevant TOR was framed in the Background Paper prejudged the issue in favour of ICMs. It was agreed that the implications for allocative efficiency was an important issue but would probably have to be looked at qualitatively, based on rough estimates of credit going to sectors and uses with obviously high (e.g. enterprises starved of working capital) or low (e.g. speculation in real estate) marginal social productivity.

On the equity impact of ICMs it was pointed out that various factors had to be unscrambled here - the relative cost of, and access to, informal credit by different borrower size-classes, the extent and redistributional impact of the transfer of assets occasioned by default, etc.

On the efficacy of monetary and credit policy, Dr. Madhur discussed at some length the results of his work for India. He said that in various money demand functions tested for India the informal bazaar bill rate had turned out to have the most consistently significant coefficient. One point that came out in the discussions was the implication of the finding of the Thai group that the better off borrowers in the rural areas who borrowed from traders and merchants with lines of credit on the banks were more likely to be affected by formal sector credit stringency than smaller borrowers borrowing small amounts mostly for consumption in the rural and urban areas. To the extent such traders relied on their own equity however, and had excess capacity, they too would be partially insulated. On selective credit controls directed to bringing commodity prices down, the point was made that these work by the government attempting to increase the cost of storage from formal to informal sector interest rates, and thereby bringing stocks into the market.

Various channels of linkage between the formal and informal sector were discussed. On the question of financial system stability and depositor security, it was suggested that one of the things that should be looked at is the extent to which institutions such as Roscas are linked with each other through chain-like structures so that if one collapses, there is a wider ripple effect, as happens in the formal sector.

Section 3 (interest rate formation, extent and the nature of market power, operational approaches)

There was considerable discussion of the practical difficulties in measuring the various components of the interest rate although the importance of attempting to do so from the point of view of the policy and operational implications in TOR 15 and 18 were recognized. In particular scepticism was expressed about the validity of assessing monopolistic or oligopolistic profits as the residual obtained after deducting the other interest rate components, an approach used in the literature. One participant advocated instead looking for direct evidence of the presense or absence of competition such as the number of lenders, barriers to entry, etc.

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Discussing their findings in their work so far the Thai participants characterized rural ICMs as being inherently uncompetitive, since many borrowers have information ties only with one lender. There was some discussion of how typical such borrowers were. It was pointed out that although the initial switching costs may be high, the presence of other lenders, traders, etc. placed limits on how onerous the terms could be made by any one lender, resulting in a situation better described as monopolistic competition. In some urban markets on the other hand, with a large number of brokers and dealers, more or less competitive conditions prevailed. The Thai participants pointed out that with the expansion of formal lending in the rural areas, informal lenders often preferred to withdraw altogether, devoting funds to other lines of activity, rather than compete for new clientele, given the importance of existing informational ties. In Tamil Nadu too, it was pointed out, many moneylenders had moved their operations to the small towns since rates of return on moneylending had fallen. In Thailand, in the rural areas, there had been a remarkable constancy of interest rates, and of marked regional differentials in interest rates, over time. Thus where lenders have not withdrawn altogether they have met competition from the banks not through interest rate cuts but by accepting into their portfolio riskier loans. The equilibriating mechanism had therefore not been interest rates, but shifts in the riskiness of the portfolio. In other areas too, participants noted the prevalence of nominally rigid, traditionally set, interest rates.

Some participants felt that the extent of market power and monopoly profits based on it was really part of TOR 3 which dealt with structure and should be discussed in relation to the various sub-markets to be described in that section. It was agreed that this would be logical.

However, a more detailed treatment of the various components of the interest rate should be attempted under TOR 13, for one or two representative sub-markets. The intention was not to come out with precise numbers but to get a good sense of the relative importance of the components as a basis for sorting markets into those where the policy approach envisaged in TORs 15 and 16 might be feasible on the hand, and those in which that envisaged in TOR 18 might be feasible on the other.

Another topic on which there was considerable discussion was the interlinkage of credit with other transactions. It was emphasized by several participants that interlinkage in itself is no presumption of the use of credit by lenders to secure better terms in other markets, or to exploit ma-ket power. Its motivation often is to obtain better information on the borrower. Thus rot only do trader-lenders interlink, they prefer to be the sole output purchaser of the borrower so as to get a more complete picture of the risk he represents. Interlinked transactions are often forward markets, and constitute a mutual control system, since in lending or forward buying, the lender/buyer also gives up some leverage.

Section 4 (an optimal policy environment)

It was agreed that the studies would conclude with a section that would attempt to identify an optimal policy environment towards ICMs.

Concluding Discussion

It was agreed that all the topics and issues in the TOR were relevant and constituted a convenient format for the presentation of the country studies, with a few minor modifications, as incorporated in the version appended to this record. However it was understood that differences between the countries in respect of data availability, the size and heterogeneity of ICMs and the policy relevance of certain issues meant that the studies would have to differ somewhat in the relative emphasis of their coverage of the various topics and issues. Section 1 of the TOR (especially TOR 3) was generally regarded as crucial, providing the empirical underpinning for the analysis in subsequent sections. Country researchers were urged also to keep in view the questions of interest to the Bank's operations identified in Section 3. The design and extent of field work was left to the country teams to finalize. While some of TOR would be supported with more empirical work than others, the country studies should deal with all the TOR, even if only as "think pieces" in some cases, so as to facilitate a comparative discussion of the issues in the final report. Even a qualitative discussion of such issues with suggestions for future methodological attacks on it would be useful.

The first drafts of the country studies should be submitted to the ADB within a year of the signing of the agreement and the release of funds. It was envisaged that a workshop would be held to review the country studies, to suggest perhaps some further analytical and presentational work, and to identify promising policy and operational

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approaches to the informal sector. This process would hopefully be completed within four to six months of the completion of the initial draft studies.

Closing the workshop and thanking participants, resource persons and observers, the Chief Economist hoped that the study would fill a major gap in our knowledge and understanding of financial markets, demolish some of the stereotypes hitherto prevalent in this relatively unresearched area, and provide policy makers with a much sounder informational base on which to formulate future policy towards the sector.

TERMS OF REFERENCE AS APPROVED BY WORKSHOP

The country studies are envisaged as a series of topics, belonging to four broad sections. The first of these will be primarily descriptive and will aim at establishing the structure and size of, and trends in, informal credit markets. The second section will deal with the role and performance of the informal sector in relation to the policy concerns referred to below. The third section will analyze interest rate formation and market structure in the informal credit sector as the underpinning for investigating the feasibility and design of the operational approaches described in TORs 15 and 18. The concluding section will attempt to identify an optimal policy environment on the basis of the findings and analysis of the study. The topics are discussed further in the Background Paper, and some suggestions on their treatment contained in the Report of the Design Workshop.

Section I

1. Estimating the size of the informal sector, both rural and urban.

2. Trends in size, and factors contributing to the growth or contraction of the informal sector in the short and long term (such as financial "repression" or liberalization in the

formal sector, growth of the volume of formal sector credit, growth of urban informal enterprises, growth in the demand for consumption credit, remittances from workers abroad received through non-banking channels, etc.).

3. Establishing the major structure of the informal sector; its segmentation and sub-markets, each with its own size, sources and uses of funds, market participants, interest rates, documentary instruments, linkages with each other, and with the formal sector. In particular, a classification of markets into homogenous borrower groups/borrowing purposes with a view to assessing the existing role and potential contribution of the informal sector in meeting them.

4. The policy and legal environment (usury laws, debt moratoria, registration requirements, restrictions on deposit taking, etc.).

Section II

5. The savings mobilization role of informal credit markets. An analysis of the sources and uses of funds to assess the net additive contribution of ICMs to savings, by offering savers a higher return, possibly, than formal sector institutions. The role of Roscas (known as paluwagan in the Philippines, arisan

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in Indonesia, pia-hueys and "chaer" games in Thailand, and chit funds in India) in mobilizing household savings in particular. The impact on the saving mobilization role of the informal sector by restrictions placed on deposit taking on NBFIs and other informal intermediaries.

6. The role of informal credit in meeting consumption needs.

7. The impact of informal sector credit on allocative efficiency.

8. The equity impact of ICMs in making credit available to small borrowers (e.g. the small enterprise sector, marginal farmers, women entrepreneurs, etc.).

9. The efficacy of monetary policy, credit policy and selective credit controls in the presence of an informal sector.

10. Interaction between formal and informal credit and the extent to which they are substitutes or complementary.

11. Channels of linkage between formal and informal sectors (e.g. trade credit, access by informal lenders to the banks).

12. The informal sector and depositor security. The incidence of fraud and "failures" as compared to that in the formal sector.

Section III

13. Interest rate formation in the informal sector. The relative importance of (i) transactions costs, (ii) risk premia, (iii) cost of funds and (iv) monopolistic (or obligopolistic) profits stemming from market power.

14. Trends in interest rates. How they compare with formal sector rates when "hidden" costs and borrower transactions costs in both sectors are included. The relationship between interest rates, collateral, the purpose, size and duration of loans, and borrower and lender type.

15. Where monopoly profits exist, the feasibility and design of policy action to engender more competitive conditions (e.g. through more effective competition from the formal sector, changes in the legal environment, encouraging new informal entrants through refinancing facilities, etc.).

16. A documenting of the advantages of informal credit as a source of possible innovations in the formal sector.

17. Regarding transactions costs and risk premia, the behavioral characteristics, practices, and mechanisms through which

informational links are formed and maintained with borrowers, and debt service ensured, with their advantages and disadvantages. In particular the importance of interlinkage of transactions in credit with those in land-lease, labor and product markets. The extent to which interlinkage is taking different forms (e.g. the increasing importance of input-dealers and output traders with land reform and the commercialization of agriculture). Is the dearth of, and control over, credit, used to obtain more favorable terms in other markets, or is the existence of contracts in other markets an enabling condition for credit transactions too, serving to increase the availability of credit and perhaps even lowering its costs?

18. Where competetive conditions exist, but the opportunity cost of funds is high, the feasibility and design of refinancing schemes to reduce the cost of funds and take advantage of the lower transactions costs of informal lenders (whether on account interlinkage or otherwise) by using them as retailers of credit.

Section IV

19. An optimal legal and policy environment towards the informal sector.

LIST OF PAPERS

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DESIGN WORKSHOP FOR A STUDY OF
INFORMAL CREDIT MARKETS IN SELECTED
DEVELOPING MEMBER COUNTRIES
28 to 30 May 1986

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Contract No.388-0249-C-00-6046-00

Appendix II
Scope of Work under contract between USAID and BIDS

C. Scope of Work:

Using the procedures outlined above, BIDS will identify specific activity lines to be investigated as case studies, will prepare detailed scopes of work for each case study, will screen and nominate contractors to conduct those case studies (five copies of each to AID/ECON, USAID/Dhaka), will analyze the results and will prepare a draft final report on urban IFMs. The draft final report on urban IFMs will draw on secondary source materials, including the data generated by USAID's Rural Finance project technical assistance team, studies conducted by Maloney and ABSharfuddin Ahmed, and other materials as appropriate. The draft final report on urban IFMs will be submitted to AID/ECON, USAID/Dhaka (in fifteen copies). It will be a major component into the draft country report on informal financial (credit) markets submitted to the ADB.

As urban IFMs appear to be rather segmented (by industry, profession or region), the case studies to be financed by this grant typically will be organized by "activity line".

D. Activity Schedule:

Since there is almost complete absence of any systematic information on urban IFM, this study will begin by initiating a number of case studies (about 8-12), less than 3 would need approval of AID/ECON representative to cover various aspects of informal transactions in major urban activity lines. The work in each of case studies would include

(a) estimating the size and identifying the factors contributing to the growth of that particular segment of IFM.

(b) describing the structure of IFM for that particular activity with details on the nature of transactions, costs of transactions (risk premia, monopoly profit, costs of fund etc.), variations in interest rates, interlinkages, etc.

(c) analysing the role of the market in mobilising savings,

(d) analysing the interaction between monetary policy factors affecting the IFM and examining and the effectiveness of monetary instruments, and

(e) providing recommendations about making the market more competitive, efficient and equitable.

The study will also include one or two case studies to examine the nature of interaction between formal and informal markets and the interface between the rural and urban informal financial transactions. While the case studies will require field level skills in investigating into a hitherto uninvestigated area, the latter would require particular aptitude in dealing with macro-economic issues. It is expected that the case/contract studies would be completed within a period of about 4-6 months.

Anothropoligical field research methods probably will dominate. A preliminary list of some activity lines that may warrant invenstigation follows:

PHASE I

(1) Textiles products: putting-out credit systems (e.g. in handloom production in which yarn is provided by merchants and in dyeing and printing in which raw cloth is provided by merchants).

(2) Metal products: formal capital sources for shipbreaking, traders, rerolling mills, dealers, small metal-working shops, wholesalers, other purchasers.

(3) Gold merchants (traditional money lending actitity).

PHASE II

(4) Trucking service: equipment purchase, routes and permits, working capital.

(5) The hundi system of infomal international financial transactions.

(6) Employee credit schemes (commonly found in large urban business organizations).

The above activities (number of cases and/or topics) may be modified and/or changed with the approval of the AID/ECON Officer, however the maximum amount the case studies may cost may not exceed Tk.500,000.00. Each case study/contract: subject to the approval of the AID/ECON Officer.

The Project Director is responsible for developing the scope of work, length of performance, the budget, and negotiating the terms and conditions of the case studies. BIDS may give up to 20% advance for each case study and seek reimbursement from USAID under the terms and conditions of this contract. Each study/contract shall have a clause whereby the contractor shall repay any advance or payment given if the study is not completed within the stipulated time.

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PHASE III

The steering committee will determine which additional activities need to be investigated (minimum 2 additional case studies).

Once the case/contract studies are completed, the Principal Investigator in charge of the urban component will prepare an overview paper on urban IFM. Apart from the aspects covered in the case studies, the overview paper will attempt an analysis of the diverse nature in different activity lines and areas. The overview paper will also emphasize and analyse the macro issues by comparing, contrasting and analysing the issues in each of the case studies.

The preparation of the urban overview paper is expected to take about 2-3 months. After its completion it will be integrated with the rural component to prepare an overview paper for the whole of the economy. The national overview will contain elements of both urban and rural overview and an analysis of various macro issues affecting the growth of the IFM in Bangladesh.

It is estimated that the preparation of the national overview will take about 2-3 months.

The Researchers

The research team for urban part will consist of the Project Director and Principal Investigator for the urban component. The case studies/contract studies will be conducted by researchers chosen for specific jobs on contract basis. The secretarial and administrative services for the Project Director and Principal Investigator will be provided by BIDS.

The case and contract studies will be conducted by researchers who are young and mobile and have particular aptitude and skills in conducting field investigations. All of them will be at least Masters in Economics with higher qualifications in particular cases.

Duties and Responsibilities:

(i) PROJECT DIRECTOR - ATIQUR RAHMAN

(a) Overall project administration, co-ordination and direction.

(b) Guiding, monitoring and assisting the Principal investigator in the conduct of his duties and responsibilities.

(c) Technical backstopping.

(d) Commenting and assisting the preparation of the final overview paper on urban component.

(e) Preparing the national overview paper.

(f) Presenting progress report of the project to the Steering Committee and attending meetings and seminars in connection with the project.

(ii) PROJECT INVESTIGATOR - NURUL AMIN:

(a) Defining, in collaboration with the Project Director, the TORs of each case study.

(b) Finding and recommending appropriate suitable researchers for each case/contract study.

(c) Drawing up an appropriate contract with a budget and the expected output.

(d) Co-ordinating and monitoring the work of the researchers in each of the case studies.

(e) Reviewing their activities and reporting to the Project Director and the Steering Committee the progress of work at least once a month.

(f) Undertaking selective field trips/visits for (d) and (e) and for conducting select interviews.

(g) Providing technical assistance in preparing the first draft of the case studies and revising the case studies subsequently.

(h) Editing the case studies for their reproduction.

(i) Presenting the findings of the case studies, along with case study researchers, to the Steering Committee.

(j) Preparing the urban sector overview paper after necessary consultation of the secondary material and on the basis of select interviews and case/contract study findings.

(iii) Advisers on Urban Informal Financial Market:

(a) Advising on the selection of case/contract studies

(b) Advising on the TORs for specific studies

(c) Helping develop contacts with objects and 'actors' to be studied.

(d) Preparing written comments on first drafts of case studies

(e) Preparing written comments on the first draft and final version of urban overview paper, and

(f) Attending Steering Committee meetings.

The Senior Advisors shall consist of: Muzaffar Ahmed, and Akhlaqur Rahman and a BIDS representative (These are paid positions and shall be out of the Fixed Cost of the Contract) and fourth position consist of a representative from the rural investigation team.

Activity Schedule and Time Budget

Activities	Time schedule
1. Defining the scope of work of case/contract studies/ identification of researchers/ drawing up the contract/ monitoring etc. of about 8-10 case studies	September 1986-January 1987
2. Field trips/commenting on case studies/scanning secondary material	February-March 1987
3. Preparation of urban overview paper	April-June 1987
4. Commenting on case studies/overview paper	February - July 1987
5. Revising overview paper and editing case studies	August-October 1987
6. Duplicating case studies and overview paper (supervision)	October-November 1987
7. Submit final report to USAID/Dhaka	December 1987

Appendix III

USING INFORMAL CREDIT MARKETS

By

Dr. Thomas A. Timberg
Robert R. Nathan Associates, Inc.
Washington, D.C.

In many of the countries of the world, a large portion of the task of financial markets is performed by informal financial agents, those who are not heavily regulated and monitored by the government. This is particularly the case for funding small enterprises and countries where all public bureaucracies are rigid and inefficient. But in these countries as well, informal financial markets are often rudimentary, and the lack of a financial system for intermediation serves as a brake on economic growth and decreases the efficiency with which the economy functions. What is at stake is not new project finance, but routine trade finance and remittance facilities -- which enable economic actors to economize in the use of their capital, and fully avail of the available productive facilities and markets. This routine finance task is easy because it supports regular, repeated transactions which are thus more predictable than the ones typically supported by development finance. The activities typically involve supporting working capital stocks (of sorts that are readily marketable) for short periods, and thus the actual security for them can be more easily liquidated, but thus more easily disposed of in the case of dishonest borrowers.

On the other hand, there exist potential savers with large sums which they employ in sub-optimal ways or in consumption that might be placed in ways that increase an economy's overall savings and investment rates,and the efficiency with which its capital stock is used. These potential savers are seeking reliable and honest repositories; in malfunctioning markets, they are often willing to accept relatively low returns.

Formal sector institutions should and can be extended to serve these needs for credit and savings. They ought to be able to create and market financial instruments that meet the needs of the savers and debtors who need the financial services. In many cases, however, they do not, and their interest in providing these services is limited, both because of their social identity and outlook, because of higher returns in other sorts of financial services (to larger units), and because of their own lack of knowledge of smaller actors (the classic "lemons" problem of the theorists). On the other hand, informal agents are often performing these services on a limited scale for smaller actors, and have a better knowledge of their characteristics. It would seem desirable to encourage them to extend their activities to improve the financing of the smaller scale activities that produce most of many economy's goods and services.

This can be done in three ways:

1. by increasing their scale of activities by providing some possibilities of refinancing them

2. by providing some legal encouragement and sanction to their activities

3. by supporting the development of infrastructures on which they can draw -- for communication, remittance, for consultation and representation, and for training and technical advice (though this last is not problematic).

Any such program of encouragement, especially in the area in which it would be most appropriate -- Africa -- would have to be experimental, since the experience with such programs is so limited. Africa is perhaps the most promising area for such efforts because on the one hand Asian and Latin American formal sector banks have extended their efforts with smaller units more effectively, and on the other hand, informal institutions are far more developed, and in fact, a variety of cooperative relationships exist between the two.

In countries where the formal sector does not function in rural areas, and for all but the largest actors -- for example, most of Francophone Africa -- the creation of institutions which would constitute a secondary market for the instruments of informal institutions. These institutions may take the forms which are familiar in Asia -- moneylenders, transporters, and couriers, market brokers, and commission agents, etc. -- but they may also be constituted of cooperatives or associations -- in all cases, with assets and a presence that makes it possible to assess their credit standing, if not of those they deal with. Rather precisely, one of the key aspects of intermediation is encountered -- the substitution of instruments issued by those generally known in the market for those who the market does not know.

As I have indicated, there is considerable Asian precedent for this, and I imagine that immigrant trading groups will take immediate advantage of such a system if they have access to it. In fact, such a system might accelerate their integration with the broader economy.

Appendix IV
Scope of Work under
contract between USAID
and RRNA

Attachment No. 1
PIO/T No. 388-0249-3-60035

STATEMENT OF WORK

Objective

The Asian Development Bank (ADB) is sponsoring a six country study of informal credit markets (also called informal financial markets--IFMs). One of the six countries is Bangladesh. The operational purpose of these studies is to investigate the feasibility of developing IFMs, e.g., by encouraging the formal (banking) sector to compete IFM interest rates down by offering more effective competition, or by encouraging IFMs, with their lower transactions costs, to act as "retail" outlets for formal institutions. The overwhelming dominance of IFMs in financing the credit needs of smaller scale enterprises, and the apparent heavy use of IFMs as savings institutions by smaller scale entrepreneurs, implies powerful links between IFMs and efforts to promote small scale enterprises.

The ADB has designated the Bangladesh Institute of Development Studies (BIDS) as the contracting institution. Accepting USAID's advice, the ADB has designated a group of individuals from BIDS, Jahangirnagar University (JNU), and the Institute of Business Administration, Dhaka University (IBA), as the team of Senior Advisors for the study. The study itself will be led by a Coordinator (from BIDS). A team of principal investigators, field supervisors and field investigators has been tentatively identified (see the draft "Informal Credit Market in Bangladesh, A Study Outline" submitted to the ADB in April 1986).

Most of the effort involved in investigating IFMs in Bangladesh will be focussed on rural IFMs. Little attention will be devoted to IFMs operating principally in market centers, towns and cities. Yet it is in these urban areas that, in the long run, the potential for generating productive jobs is greatest. USAID/Dhaka's commitment to stimulating employment through small enterprise development is predicated on knowing how institutions affecting these enterprises operate. Learning how IFMs work is an essential part of our strategy to promote small enterprises.

Accordingly, USAID/Dhaka will supplement ADB funds for this study. The objective is to investigate urban IFMs, particularly those that appear to be closely linked to smaller scale enterprises. AID funds will be needed to support two components of the study. The first will provide a U.S. expert to participate part-time

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as a member of the team of Senior Advisors. The second will involve the collection/analysis of information on urban IFMs operating in Bangladesh. This work scope is for the first component.

The U.S. expert will make two visits to Bangladesh of about four weeks each. (A third visit is anticipated to take place around December 1987. During the third visit, the expert will help draft the final Bangladesh country report, evaluate the work-in-progress, and participate in a Dhaka-based seminar on the study findings. USAID/Dhaka anticipate funding this third visit out of FY 87 PD&S funds.) The specific work scope presented below covers these two visits.

Scope of work

The expert will provide overall guidance to the study of urban IFMs in Bangladesh. Specifically, he will help design (in his first visit) and monitor (in his second visit) the case studies, advise the Coordinator and principal investigators, and work in close consultation with the Senior Advisors from BIDS, JNU and IBA.

In performing these tasks, he will address numerous key issues that are relevant to any study of IFMs. These include:

- Estimating the size and identifying the factors contributing to the growth of urban IFMs;

- Describing the structure of diverse IFMs, including black markets and the hundi system, and including linkages to other financial markets (including rural and formal markets);

- Describing the policy, legal, social and institutional environment in which IFMs are imbedded;

- Analyzing the role of IFMs in mobilizing savings, allocating investment funds efficiently, contributing to equity objectives (e.g. access to small savers and borrowers), meeting consumption demands for funds;

- Analyzing the efficacy of monetary and fiscal policy instruments in the presence of active IFMs, and analyzing the interactions of formal and informal financial markets;

- Assessing the relative importance of transactions costs, risk premia, costs of funds and monopolistic (or oligopolistic) profits in determining interest rates in IFMs;

- Improving our general understanding of how project interventions may promote development through introducing competitive practices where they are absent or introducing schemes to use urban IFMs as retailers of credit where competitive conditions exist.

The expert will be responsible for helping identify the specific topics to be investigated, and for helping draft detailed work scopes for the contractors who will conduct the field research on urban IFMs. He will participate in selecting those contractors. The research will be conducted as a series of related intensive case studies by activity line (e.g. one such activity line could embrace lumber felling operations, saw mills, furniture makers, wholesalers, retailers, final consumers).

During his second visit in addition to the tasks defined above, he will monitor the activities of the contractors, accompanying them in their field work as necessary. He will offer advice on mid-course corrections as warranted.

Reports

The expert will work closely and coordinate fully with AID/ECON USAID/Dhaka. The expert will prepare detailed trip reports of 30-50 pages describing his activities. One report will be submitted for each visit. These reports will be submitted in eight copies prior to his departure from Dhaka. These reports will not only describe his activities but also contain specific recommendations on actions to be carried out by USAID, ADB, BIDS-JNU-IBA, and case study contract personnel after his departure.