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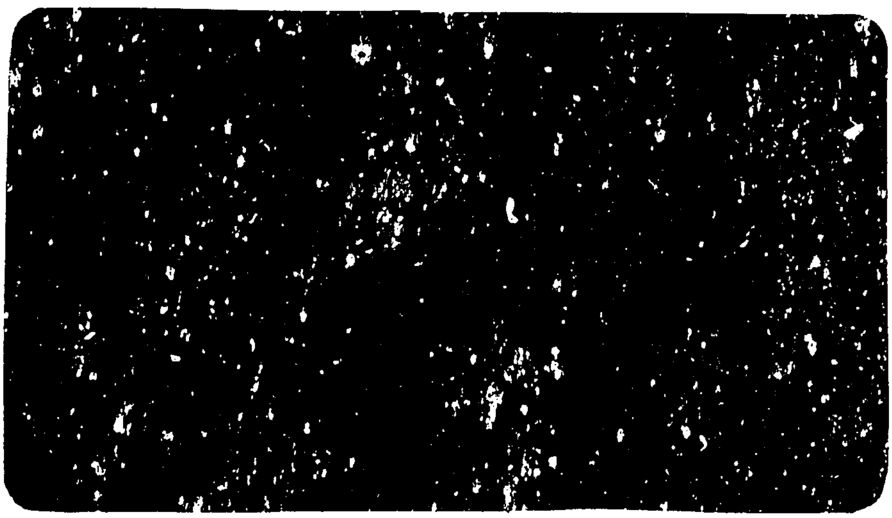
STUDIES ON INFORMAL FINANCIAL MARKETS IN BANGLADESH



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URBAN INFORMAL FINANCIAL MARKETS IN BANGLADESH

-An Overview-

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PREFACE

As in many developing countries, the informal financial markets in Bangladesh are alleged to provide the bulk of the credit needs of the economy, particularly to the small scale sector which has little access to the formal (institutional) sources of credit. Despite various attempts to control and regulate informal financial transactions, their scale and pervasiveness of operations have expanded unabated. In the long debate on the usefulness and the performance of the informal financial market operations, and associated issues like the determinants of interest rates, interlinkages among transactions, etc., some have labelled these informal transactions as usurious, as 'fetters on growth' while others have considered them as desirable adjuncts to the process of brisk growth in trade and commercial operations. Corresponding to these two views, two diametrically opposite policy frameworks are envisaged; the first aims at controlling and ultimately eliminating informal financial transactions while the second aims at expanding the fund flows and increasing the competitiveness in the informal sector. Both lines of arguments however agree that there are imperfections in informal financial markets and that the interest rates usually obtaining in these markets are on the higher side.

Despite the considerable operational significance of the issues involved, and the implications these have for developing an optimal policy environment, information on these markets in

Bangladesh remain highly inadequate. The study on the informal financial markets in Bangladesh, conducted by the Bangladesh Institute of Development Studies (BIDS) and sponsored by the Asian Development Bank and the US-Agency for International Development (US-AID), attempts to fill up this gap in information and analyse some select issues such as the growth and the structure of the markets, formation of interest rates, mobilisation and use-efficiency of resources.

Under the US-AID sponsored component (for the TORs of the US-AID component, see p.3-4), a series of eight studies has been conducted on urban informal financial markets. The studies along with the names of respective researchers are:

Urban IFM and the small scale cotton and handloom weaving sector in Bangladesh: Norsingdi area
-- Dr M Reazul Islam

Urban IFM and the small scale cotton and handloom weaving sector in Bangladesh: Shajadpur area
-- Mr Shamsul Alam Mia

Urban IFM and the construction sector in Bangladesh
-- Mr Ghausul Alam Khan

Urban IFM and the leather industry sector in Bangladesh
-- Dr Naushad Faiz and Dr Reazul Islam

Employee Credit Schemes in selected urban establishments in Dhaka
-- Mr Nazmul Ehsan Fatmi

Wage Earner Scheme and the informal financial transactions in Bangladesh
-- Mr Farid Bakht and Dr Raisul A Mahmud

IFM and the goldsmiths and gold merchants in Bangladesh
--Dr Ziaush Shams Huq

The small scale engineering and the metal fabrication units and Informal Financial Markets
-- Dr D Bhattacharya

All these case studies have been revised and are being brought out as working papers of the project.

This overview on urban IFM is based on the findings of the eight studies mentioned above. Given complete absence of any information on the urban informal financial market, we had to depend only on the information collected through the case studies as well as on our personal interviews with a number of actors in this area. Since moneylending is still considered to be a rather undesirable form of activity from the religious point of view, it was rather difficult to gather adequate information on various aspects of moneylending and discover its various forms. Despite these difficulties, we have been able to gather some information and analyse them in a consistent framework. We have also been able to indicate some policy recommendations regarding the working of the urban informal financial market.

The recommendations put forward at this stage however remain rather incomplete as informal financial transactions often spread across rural and urban activities. A comprehensive set of recommendations can only be arrived at after we complete an overview on the rural informal financial market. The preparation of the overview paper on rural IFM, based on another set of 6 cases studies and a detailed survey in three upazilas in Bangladesh, is in progress. The final synthesis of the rural and the urban studies will be done later, hopefully by the end of December 1988.

The office of Programme Economics, USAID/Dhaka, has provided continuous technical support and encouragements for which I am grateful. Dr P B Ghate of ADB also provided much encouragement and support for the study. His issues paper was particularly helpful in clarifying many of the issues involved. Dr Muzaffer Ahmad of IBA, Dhaka University provided guidance and support during the initial phases of the project. Dr Tom Timberg, Consultant, US-AID, also provided continuous support for the project. His prior experience with IFMs in India and elsewhere proved to be extremely useful in sharpening the focus of the study. We would also like to thank US-AID for sponsoring this study.

I am grateful to a number of my colleagues at BIDS for their support, help and compassion. Our Director General, Prof. Rehman Sobhan took keen interest in the project and despite his very busy schedule discussed many of the intricate issues involved at length. He also made detailed comments on some of the case studies.

It is not possible within this limited space to thank all the persons who helped us in this project. We remain grateful to all of them. Despite our best efforts and the help we received from different quarters, there are certain unavoidable deficiencies in the data and analysis. Much of this is due to the lack of adequate information on the topic. While we assume

full responsibility of the other deficiencies, we hope that future studies along this line will be able to benefit a great deal from this particular study.

Atiq Rahman
Project Director

I INTRODUCTION

Informal financial markets (IFMs) constitute an important part of the financial system of many Asian countries. In some countries ICMs have become quite organized playing an important role in financial intermediation; in others, they have remained unorganized and fragmented. Traditionally IFMs have been regarded as exploitative in character, operating in segments, wielding considerable monopoly power and frequently lending at very high interest rates. Very often, credit operations are thought to be interlocked with transactions in other markets such as land, labour and product, sometimes enabling lenders to extract monopoly interest and sometimes leading to a rather benign effect on interest rates through reductions in transactions costs and risks of default. The IFM with varied transactions, interlinkages and fragmentation has thus become an interesting study area of considerable operational significance - the significance deriving from the impact IFMs have in mobilizing savings, allocating resources and affecting equity objectives.

IFMs in Bangladesh provide the bulk of the credit needs of the economy. Although there are no firm estimates, fragmentary evidence based on various micro-surveys conducted over the last two decades suggest that IFMs in Bangladesh may be providing as much as two-thirds of the total credit needs in the rural sector.

Evidence on the size of the IFM for the urban sector is not available, but rapid urbanization is alleged to have forced a growing segment of urban entrepreneurs, households and workers to fall back on moneylenders, pawnbrokers, traders-cum-lenders, etc. This has happened despite an encouraging growth of formal financial institutions in urban areas as these institutions cater mostly to larger enterprises, leaving smaller entrepreneurs, traders and others to depend on the IFM for their credit needs.

Despite the significance of IFMs in Bangladesh, there is a dearth of in-depth information on various issues of interest -- both contemporary and historical. The changing nature and the role of IFMs, particularly the role IFMs play in mediating and allocating resources, in affecting income and asset distribution and in determining the efficacy of monetary policies are important study areas for developing countries such as Bangladesh.

The urban informal financial markets study has been undertaken by the Bangladesh Institute of Development Studies (BIDS) and USAID/Dhaka and is meant to delineate the operation of the informal financial market in urban areas of Bangladesh. The study is part of a broader study on the IFM in Bangladesh covering both urban and rural areas, with the study on rural IFM also conducted by BIDS and funded by the Asian Development Bank (ADB). The ADB intends to use the Bangladesh study as the basis for a comparative study of IFMs in five Asian countries, viz. the Philippines, Indonesia, Thailand, India and Bangladesh. Once the rural studies are completed, BIDS will provide a synthesis of the principal findings covering both the urban and the rural sectors, so as to provide the basis for the comparative study.

The broad objectives of the BIDS study on urban IFM are to examine:

i) the role played by the urban IFM in providing financial support to urban small scale enterprises;

ii) the desirability of developing urban IFM in order to promote the urban informal sector, particularly the small scale enterprises which have little access to formal sector institutions; and

iii) the modalities for promoting urban IFM, should such promotion be considered desirable.

In view of the heterogeneity of the many segments of the urban IFM, it was decided that various sub-markets would be studied separately, through surveys as well as through more participatory research methods such as unstructured interviews with actor participants. With this end in view, a number of in-depth case studies of various urban and semi-urban based activities were undertaken. A listing of the activities studied is provided below.

i) The leather and leather products industry

ii) The small engineering and metal fabrication sector

iii) The construction sector

iv) The handloom and small textile sector in the Norsingdhi area

v) The handloom and small textile sector in the Shajadpur area

vi) The goldsmiths/gold merchants and the gold jewellery business

vii) Overseas remittances and their uses

viii) Informal employee credit schemes.

The first five studies have yielded insights into the workings of the IFM in supporting the respective activities. The gold study provides an idea of the extent of smuggling and of the role of the IFM in supporting what are possibly non-productive activities. The remittance study provides an estimate of remittances, transmitted through legal as well as illegal channels, and the uses to which such remittances are put. Finally the study on informal employee credit schemes shows the role of such schemes in savings mobilization.

II HISTORICAL BACKGROUND OF IFMS IN BANGLADESH

Historically, the informal credit market (ICM) has always been an important part of the financial system in rural Bangladesh. During the British period, the ICMs in both the rural and the urban areas were dominated by the **banias**, **Marwaris** and the **kabuliwalas**. While the banias were a particular caste of Hindus indigenous to Bengal, the other two groups had their origins outside the area. The first two groups mostly linked credit with trading operations while the kabuliwalas engaged in usurious lending.

From time to time the British raj tried to control ICMs by enactments limiting usury and prohibiting land transfers in case of defaults. The Taccavi system of lending to cultivators to meet parts of their production cost was the only major institutional challenge to the otherwise unhindered operation and progress of the ICM.

We do not have enough readily available information on the extent, nature and composition of the ICMs during the British period. All we know from fragmentary evidence is that the institutional challenge to usury in the form of Taccavi and co-operative credit movements could not make much of a dent in the significant burden of indebtedness in the agricultural sector. The evidence also suggests that the operation of the ICMs could have led to a transfer of assets from the poor to the rich, worsening the rural income distribution. This particular aspect is apparent from the passing of two acts (Bengal Moneylenders Act and Bengal Agricultural Debtors Act) towards the early part of this century prohibiting transfer of assets through usury. The studies conducted during the British period mostly concentrated on the Taccavi system or were by-products of the land settlement operations. These revealed very little about the workings of the ICMs. It was not till the late twenties that a series of enquiries (Royal Commission on Agriculture, 1926; Bengal Provincial Enquiry Committee of 1929 and Bengal Board of Economic Enquiry of 1934) did try to investigate the extent of indebtedness in the rural areas and relate those to aspects such as farm and family size, income, expenditures, etc.

The partition of the Indian sub-continent and integration of the area now constituting Bangladesh had a considerable impact on the nature and the growth of ICMs. The large scale migration of **banias, marwaris** and **kabuliwalas** had a considerable dampening effect on the ICMs. The filling-up of the vacuum in the informal money market by the muslims was constrained by their generally poor economic condition but more importantly by the religious and social values which prohibited usury. The economic compulsions took time to dispel these social and religious values and moneylending therefore developed in covert fashions under the guise of advance payments for commodity transactions, land leasing and hiring of labour. Pure form of moneylending and usury only developed later mostly remaining behind other forms of activities and therefore avoiding social sanctions against usurious moneylenders.

The changes in the ICMs in the fifties in the wake of the abolition of all rent receiving rights by the 1950 State Acquisition and Tenancy Act and the migration of urban and village lenders are summarized in the Credit Enquiry Commission Report of 1959. The report noted that the "village bania" who was "both moneylender and trader" ... "was almost completly wiped out in Pakistan and upto the present time (i.e. 1959) no real substitute has emerged. Post-partition studies of the credit situation clearly reveal the eclipse of the moneylender; his maximum contribution was placed at 4.2 per cent in one survey as against approximately 70 per cent in India," (P. 8). The moneylenders have been replaced by "unorganized sources of credit of which the largest is friends, relatives and well-to-do neighbours. Another source is the landlord but from this source may not be available to the same extent in the wake of the land reforms" of 1950 (P. 13).

While there has been a number of studies on the ICMs in rural Bangladesh, there are none, as far as we are aware, on urban ICMs. Most of the studies were based on micro-surveys of rural informal credit markets through enquiries into the sources of loans and their uses, borrower's profile and the interest rates charged. Some also considered the composition and the nature of collaterals offered as security for loans. Only a few studies investigated into the alleged interlinkages among transactions in various markets such as land, labour, product and, of course, credit. The rather narrow focus of many of the studies therefore left out issues which are also important for the development of the financial system of the country. Most of the studies did not, for example, raise and examine issues such as allocative efficiency of ICMs, the role of ICMs in mobilizing domestic resources, efficient utilization of resources thus mobilized, the impact on growth and equity of the operations in ICMs and the effectiveness of monetary policy (in a 'repressed monetary regime') in the context of the presence of ICMs. Moreover, none of the studies examined and analysed the determination of rural interest rates -- how much of it is determined by the opportunity cost of lending and how much by other components such as the cost of administering credits and transaction costs, risk premium (due to defaults) and monopoly element (arising out of segmented credit markets and overall capital scarcities). Lack of understanding of the role and functioning of the ICMs in Bangladesh has therefore constrained formulation and implementation of appropriate development policies and programmes, especially those involving or affecting ICMs.

The varied characteristics of ICM in the urban sector have also remained unexplored although casual discussions on the urban informal sector indicate the existence of finance brokers and traders with financial interests. The horizontal and vertical linkages of these financial intermediaries as well as their links with formal financial institutions (FFI) have also remained unexplored. To the extent that such key financial sector issues remain unexplored and uninvestigated, and to the extent that the development of the economy requires varied financial support from both FFIs and ICMs, the progress of the economy is handicapped by the lack of an optimal policy regime.

III THE SIZE OF THE IFM IN URBAN AREAS

At the outset, it would be useful to dwell on the characteristics of the IFM that distinguish it from the formal financial sector. IFMs are those that are not regulated or monitored by the banking authorities. However, the formal and the informal markets do not form two discrete financial enclaves. "The two sectors form, rather, a continuum, with segmentation within each sector, and many linkages between the two."[1] The informal sector is distinguished by the fact that it is able to function outside the purview of regulations imposed on the formal sector in respect of capital, reserve and liquidity requirements, ceilings on lending and deposit rates, mandatory credit targets, and audit and reporting requirements. The absence of regulations along with smallness of size (with most informal lenders operating in specific areas of the market where personal knowledge of borrowers is possible) provides a flexibility to IFM operation not enjoyed by their formal counterparts. Transaction costs can be reduced to a very minimum. The interest rates can be fully adjusted to cover the opportunity cost of funds as well as any risk of default that may remain despite their close informational links with borrowers. As a result, informal sector credit is more costly than formal sector credit. However, informal credit is more easily available to borrowers whose

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1 Some issues for the Regional Study on Informal Credit Markets, Discussion Paper, Asian Development Bank, Manila, Philippines, 1986, p.10.

credit needs tend to be neglected by the formal sector (for reasons such as risk, lack of collateral, and high per unit administrative cost of small loans). Finally, informal lenders are seen to rely on their own funds to a greater extent than lenders in the formal sector. However, they also accept deposits in certain cases and transmit such deposits to more productive uses. In Bangladesh's urban centres, informal lenders are seen to operate mostly as individuals (e.g., friends and relatives, businessmen, moneylenders, input dealers, end users of products, etc.) and to a lesser extent also as groups of individuals organized mutually (e.g., informal employee credit schemes).

Only very tentative estimates of the size of informal credit markets (ICM) are available, both in absolute terms and relative to corresponding formal markets. Studies from about the middle of the seventies until now show that the relative size (defined as the percentage of credit from non-institutional sources) could be anywhere between 33 (Rural Finance Experiment Project, RFEP, 1981-82)[1] and 91 (Alamgir and Rahman 1974) per cent.[2] Both these estimates can be considered rather extreme as the former covers areas where the nationalized commercial banks have opened up new branches and experimented with different variants of formal

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[1] Rural Financial Experimental Project, 1981/82, (a) Baseline Survey II, (b) Borrower's Financial Survey, (c) Social Anthropological Survey of Borrowers -- GOB and USAID

[2] Alamgir, M and Atiq Rahman (1974): Savings in Bangladesh: 1959/60 - 1969/70, BIDS Research Monograph No.2, BIDS

lending schemes while the latter includes areas which were under the grip of famine in 1974 and therefore exposed to usurious lending from informal sources. If we include another study by RFEP, the mean relative size of the ICM in Bangladesh comes to about 78 per cent. If, however, one takes all the major studies reporting on the relative size since 1974, the mean size would be about 63 per cent (Hussein 1983).[1]

The case studies of urban enterprises that have been conducted have yielded some insights into the workings of the urban informal credit markets with respect to the relative size vis-a-vis institutional credit sources, the nature of credit operation, the terms of credit and other aspects of ICM operation. Basically, urban enterprises, particularly the small-scale enterprises, are seen to depend to a large extent on the ICM for their credit needs, especially working capital needs. The case studies have considered in detail the financing of initial investment, expansion capital and working capital for the enterprises.

Financing of Initial Investment

Table 1 reveals the average size of initial investment for the various enterprises studied and the mode of financing. Notice that informal credit has an insignificant role to play in

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Hussein, Md Ghulam (1983): An Analytical Review of Non-Formal Rural Credit Studies in Bangladesh, A/D/C.

TABLE 1

FINANCING OF INITIAL CAPITAL

	Average initial investment per enter-prise (Tk.)	Financing (%)		
		Own capital	Borrowed capital	
			Institu-tional sources	Infor-mal sources
Small engineering and metal fabrication	114,600	63.6	5.1	31.3
Leather & leather products				
Wet blue manufacturers	51,900	100.0	-	-
Crust leather producers	1,310,000	80.0	20.0	-
Footwear producers				
Small	10,000	100.00	-	-
Large	225,000	11.1	88.9	-
Other leather goods				
Small	10,000	100.0	-	-
Medium	27,500	100.0	-	-
Large	1,500,000	100.0	-	-
Traders				
Hides and skins	20,000	87.5	-	12.5
Brickfield (ordinary)	1,650,000	100.0	-	-
Handlooms (Norsingdhi)				
Pitloom	813	100.0	-	-
Semi-automatic loom	9,512	94.7	-	5.3
Power loom	44,374	95.0	-	5.0
Small jewellery shop	679,000	85.0	-	15.0

the financing of initial investment. Informal credit is essentially short-term in nature and is not given out to finance what are considered 'risky' initial investments in machinery and equipment. It is clear that entrepreneurs have to rely on their own internal resources in financing start-up capital. Institutional financing is available, but only to large units such as to large footwear and crust leather enterprises in the sample. Some amount of institutional financing has also been available to the small engineering and metal fabrication workshops in Dhaka -- this is on account of a special assistance programme undertaken by BSCIC for this sector.

Sources of own capital in the financing of initial investment are mainly savings, sale of assets, accumulation from other businesses, money obtained from parents, etc. Savings and sale of assets account for a substantial part of own funds. Thus in the case of handlooms in the Norsingdhi area, it has been seen that savings account for about 60 per cent of total initial capital and sale of assets for about 26 per cent.

The principal lenders in the ICM are seen to be friends and relatives, moneylenders and others. In the case of light engineering workshops, of the 31.3 per cent of initial capital obtained from informal sources, 28.8 per cent came from friends and relatives (about 79 per cent of total capital borrowed from informal sources), 0.2 per cent from moneylenders and 2.3 per cent from others. In general, the contribution of borrowed funds (both institutional and informal) in the financing of initial capital is seen to be rather limited. Entrepreneurs rely primarily on their own resources in setting up their enterprises.

Financing of Expansion Capital

Expansion capital is required for financing the acquisition of new fixed assets and supplementary working capital. Table 2 shows the average amount of expansion capital per enterprise for a few selected industries and the mode of financing.

TAPLE 2

FINANCING OF EXPANSION CAPITAL

	Average expansion capital per enterprise (Tk)	Financing (%)		
		Own capital	Borrowed capital	
			Institutional sources	Informal sources
Small engineering	118,462	49.1	23.1	27.8
Leather				
Wet blue	1,559,000	49.9	49.7	0.4
Crust	1,976,000	44.3	55.7	-
Handloom (Norsingdhi)				
Pitloom	4,167	62.6	-	37.4
Semi-automatic loom	17,154	82.8	-	17.2

It can be seen from Table 2 that own funds were principally used for financing expansion of the enterprises in the case of the small handloom enterprises; borrowed funds that were used came solely from informal sources. For small engineering industries, both institutional and informal sources of borrowing figured prominently; here the institutional borrowing was made possible due to the initiation of BSCIC's special programme for the sector. For the large wet blue and crust leather producers, institutional sources of borrowing were the principal means of expansion capital financing. It would seem that small enterprises have little or no access to institutional finance (unless special programmes are initiated) for expansion of their enterprises, and are found to borrow from informal sources.

The source of own funds are principally reinvestment of profits and sale of assets. For the engineering workshops, reinvestment of profit accounts for 26.4 per cent of expansion capital (54 per cent of own capital), sale of assets for 12.1 per cent and reinvestment of savings from other sources of income for 10.6 per cent. For the pitloom enterprises, 43.1 per cent of expansion capital was financed through reinvestment of profit, 17.3 per cent from sale of assets, and 2.3 per cent from other sources. For the semi-automatic loom enterprises, 50.9 per cent of expansion capital was financed through reinvestment of profit, 29.1 percent through sale of assets, and 2.7 per cent through other sources.

Sources of informal finance were friends and relatives, landlords, businessmen and others. In most cases, local elite such as landlords, politicians, or chairmen of local councils provided security. Against this, they may have obtained some intangible benefits from the entrepreneurs. In the case of semi-automatic loom units, about 25 per cent of the borrowed capital was from friends and relatives.

Larger units with bigger scale of operation generate more investible surplus and are capable of generating relatively more resources from internal sources. Even then they have to supplement their funds with IFM credit. In the case of engineering workshops, it was observed that whatever institutional credit has been disbursed, only relatively larger units have benefitted from it. The handloom enterprises in fact have received no institutional credit for financing expansion of their enterprises. There is therefore a large measure of dependence on informal sources, with the dependence higher for the small pitloom units compared to the relatively larger semi-automatic loom units.

Financing of Working Capital

While the IFM does not play a prominent role in financing initial start-up capital and expansion capital, its role becomes highly visible when one considers working capital financing. It is seen that a considerable part of the working capital requirements of the small enterprises is financed by borrowing from the IFM, credit purchases of raw material being the principal means through which credit is channelized. Wholesalers and retailers emerge as the principal lenders of short-term working capital funds in the IFM.

Shortage of working capital has been identified by most of the entrepreneurs as the principal constraint limiting capacity utilization and profitability of the enterprises. For example, 59 per cent of the small engineering workshop entrepreneurs identified working capital shortage as their major problem despite the fact that special institutional (BSCIC) funds have been made available for this sector. Hence, even when entrepreneurs are able to gather the initial venture capital, many of the firms fail to grow and sustain their production because of lack of adequate flow of credit to meet short-term operating expenses. **Table 3** shows the modes of working capital financing for the various industries surveyed.

A glance at Table 3 shows the tremendous importance of borrowing, particularly borrowing from informal sources, in the financing of working capital. Purchase of raw material constitutes the major element of working capital. The main burden of financing relates, therefore, to the financing of purchases of raw material.

TABLE 3

WORKING CAPITAL FINANCING

('tk) Per Enterprise

	Total working capital	Purchase of main raw material per month	Financing			
			Institutional sources	Informal sources		Total borrowing
				Credit purchases	Cash borrowing	
Small engineering	77,076	-	-	28,518	-	-
Brickfield	333,333	-	50,000	105,000	45,000	200,000
Gold jewellery shop	146,641	112,057	Nil	71,773	8,057	79,830
Leather						
Wet blue	1,300,000	1238,900	-	863,389	-	-
Crust	13,900,000	12729,620	-	9249,342	-	-
Leather goods	-	738,661	-	471,024	-	-
Handlooms (Norsingdhi)						
Pitlooms	-	8,883	2,666	4,337	-	-
Semi-automatic	-	34,190	6,771	18,021	-	-
Powerloom	-	21,558	6,667	7,656	-	-
Handloom (Shajadpur)						
Semi-automatic	-	120,952	12,451	36,917	7,559	88,935

Borrowing from institutional sources and cash borrowing from informal sources are seen to play an insignificant role in working capital financing. The principal mode of financing consists of credit purchases of raw materials from input suppliers. This shown in Table 4.

TABLE 4

PROPORTION OF RAW MATERIAL BUDGET ON CREDIT AND THE IMPORTANCE OF IFM IN CREDIT SUPPLY

	% of raw material bought on credit	% of informal borrowing in total borrowing	% of credit purchase in total borrowing
Brickfield	38.23	75	52.5
Gold jewellery shop	64.05	100	89.9
Leather and leather goods			
Wet blue	69.69	–	–
Crust	72.66	–	–
Leather goods	63.75	–	–
Handloom (Norsingdhi)			
Pitloom	48.82	–	–
Semi automatic looms	52.71	–	–
Powerlooms	35.65	–	–
Handlooms (Shajadpur)			
Semi-automatic looms	30.52	50	41.5

The preponderance of credit purchases points to the importance of traders (wholesalers and retailers) in extending vital short-term credit to the producers. For smaller producers, such trade credit forms the lifeline of their business, since institutional loans cannot be obtained and cash credit from informal sources is hard to come by. It may be hypothesized in fact that the growth of trade credit has led to the decline of the conventional moneylender who can no longer resort to usurious moneylending practices. The bulk of cash credit from informal sources comes from friends and relatives who do not normally charge any interest but count on the reciprocity of the relationships which give them access to loans when they too are in need. In most of the cases, persons identified as moneylenders are in fact businessmen who tend to use short-term surpluses in a profitable lending activity, provided of course, that they know the borrower personally and can count on prompt repayment of funds.

IV TRENDS IN SIZE

Reliable information on the size of the ICMs at different points in time is not available. It is therefore not possible to accurately present the time trend in the size of the ICM or to examine how far its share in the financial system is related to different variables such as the flow of credit from formal sources, the variations in interest rates, etc. The scattered evidence however allows us to note the broad trends which show a decline in the immediate post-partition years (post 1947 period). The ICM has since then staged a comeback when the Muslim lenders gradually started lending operations. This trend might have continued till the mid-sixtees after which the formal agencies may have increased their share. However, it was unlikely that the formal credit sources could have posed a serious challenge to the ICM.

It could have been expected that with the launching of special institutional credit programmes for particular sectors (e.g., Handloom Credit, 1983; BSCIC programme for engineering workshops; etc.), there would be a decline in the ICM operations and/or a reduction in interest rates. The government decided in early 1983 to extend a direct credit of Tk 1000 million to the handloom weavers, especially to meet their working capital needs. Loans were distributed through three commercial banks (Sonali, Agrani and Janata) and the Krishi Bank. In 1983-84, about Tk 955 million was disbursed among 103971 weavers. A capital injection of such dimension to the sector is expected to have some impact on ICM transactions. In the Norsingdhi area alone, an amount of Tk. 151 million was disbursed. About 20 per cent of the pitloom units, 57 per cent of the semi-automatic loom units and 17 per cent of the power loom units in the Norsingdhi area received loans, the average amount of loan being Tk 13,330 for pitloom, Tk 15,350 for semi-automatic loom and Tk 40,000 for powerloom units. The handloom loan was intended for all weavers but it failed to reach a large section of small weavers.

Among the handloom units which received the institutional loan, none were observed to take cash credit from informal sources for working capital or other uses. The units did not borrow (cash loans) from non-institutional sources because of the high rates of interest. Cheaper institutional credit given for working capital purposes was diverted to finance expansion while raw material continued to be purchased under deferred payment basis as before. Hence the institutional credit injection did have an effect on borrowing from informal sources. It was seen, however, that for pitloom weavers, credit purchases of raw materials were higher for those who had taken the loan compared to those who did not. It is possible that the small pitloom weavers diverted the low cost loan to the purchase of machinery and equipment thereby modernizing their units. This in turn raised raw material requirements which were then met through larger credit purchases. For semi-automatic loom and powerloom units, banks loans reduced the dependency on credit purchases, and hence on the IFM.

The problem with credit schemes such as the Handloom Loan 1983 is that much of the credit does not go to the parties for which they are intended. It is well known that a significant portion of the credit went to touts and middlemen on the basis of false passbooks showing ownership of non-existent looms. It is possible that some of these loans were diverted back to the weaving sector through the IFM. This would explain why a significant reduction in IFM operations was not observed despite the large magnitude of the credit injection.

Another interesting case was the introduction in 1986 of the BSCIC programme (for the small engineering industries of the Jinjira and Dholaikhal areas) which allocated Tk. 50 million for disbursement through special credit schemes. Coverage was again not very widespread; only 17.7 per cent of the units received loans. Overall bias of the loan operation has been towards bigger loan sizes. Dependence on informal credit declined for the units that had borrowed under the programme; however, given the strict collateral/hypothecation requirements, the delays in loan processing, the payoffs to officials, and other costs, the advantages of informal credit continue to attract the vast majority of entrepreneurs.

V NATURE OF INFORMAL CREDIT OPERATION, LEVEL OF INTEREST RATES AND IDENTIFICATION OF LENDERS

As seen in Section IV, trade credit is the major form of informal credit transactions for the enterprises studied. Basically, the credit chain extends from the primary input supplier (producer/inporter) to wholesaler to retailer to producer. Raw materials are purchased on credit terms at each stage with the payment deferred for a given period and a premium added on to the price. The duration of credit and the premium on credit varies from transaction to transaction and depends on the nature of the relationship between the contracting parties. Broad ranges can however be identified and used to calculate implicit rates of interest. Table 5 shows the varied terms in the different sub-markets studied.

The table reveals the variety of terms on credit purchase/sales/advance purchases of input/output that exist in various sub-markets and on transactions at different stages in the same sub-market. Besides credit purchases of inputs which are seen to prevail in each submarket studied, a number of interesting variations has been observed:

(i) Credit purchases of inputs and repayment in output : This has been observed in certain cases in the handloom subsector in both Norsingdhi and Shajadpur. Output in sold at a discounted price, with the discount representing the implicit interest on the credit.

TABLE 5

TERMS OF CREDIT ASSOCIATED WITH CREDIT PURCHASES AND SALES

	Duration of credit (days) (1)	Premium on credit (%) (2)	Implicit rate of interest (%) (3)
Leather and Leather goods			
i) Purchase of hides and skins by tanneries	30-120	7.69-8.38	23-102 (78)[a]
ii) Purchase of chemicals by tanneries	30-120	2.00-5.00	6-61 (24)
iii) Sale of leather by tanneries	30-120	8.00-10.00	24-122 (49)
iv) Purchase of finished leather by leather goods producers	15-90	9.99	41-243 (61-81
v) Purchase of accessories by leather goods producers	30-60	0.02	12-24
vi) Sale of footwear by small footwear producers	30-90	13.71	56-166 (83)
vii) Purchase of cowhide by traders	30-90	16.67-18.75	68-228 (101-114)
Handlooms (Norsingdhi)			
i) Purchase of yarn from yarn wholesaler by:			
Pitloom unit	15.5	2.85	67
Semi-automatic loom unit	18.8	2.74	53
Powerloom unit	17.8	2.50	51
ii) Purchase of yarn from yarn retailer by:			
Pitloom unit	10.3	2.55	90
Semi-automatic loom unit	11.8	2.44	75

Contd. Table 5 .....

	(1)	(2)	(3)
iii) Purchase of yarn by semi-automatic loom, repayment in output	11.4-14	(-0.14)-(-0.15)[b]	50-58
iv) Dyeing of yarn on credit by:			
pitloom unit	15	5.00	122
Semi-automatic loom unit	15	4.00	97
Brick making			
i) Advance purchase of bricks by wholesaler from producer	90-120	-	82-109
ii) Credit sale of bricks by wholesaler to contractor/ end-user	1-2 weeks	3-5	78-261 (104)
Steel rerolling mills			
Advance sale of steel by rerolling mill to wholesaler	60	-	50-75 (63)
Cement trade			
Advance sale of cement by importer to wholesaler	-	-	40-60
Gold jewellery shop			
Purchase of gold from bullion traders	15	2.94	72

(a) Figures in brackets depict modal interest rates.

(b) When credit is repaid in output, there is a discount on the output price, indicating an implied rate of interest.

(ii) Advance sale of output, as seen in the brick and steel rerolling industries and cement business. Here payment for their output is made in advance by the traders at a stipulated rate, and the difference between this rate and the market price prevailing at the time of delivery represents the implicit interest paid.

(iii) Advance purchase of input with a discount on the price of input at the time of delivery. This is observed for many wholesalers in the handloom and cement trades.

Whatever be the mechanism, the flow of trade credit appears to be the most important aspect of IFM operation in terms of contribution to credit flows. The success of the mechanism lies in the fact that the transactors are both actors in the same subsector, are well connected through the business and know each other well. One has a product to sell; the other has a need to buy it. The deferred payment mechanism allows for continuous sales in a market situation where information costs are low and risks are minimal. With numerous traders, there is an element of competition which stabilizes interest rates at reasonable levels. Clearly the profitability of the enterprises at the margin justifies the payment of the premium charged, so that the credit is in fact utilized productively.

For the smaller enterprises who have no access to institutional funding, the credit purchase mechanism is often the only way to keep their business operating. That institutional funding agencies will not lend to these enterprises at current prescribed rates of interest shows that higher interest rates are justified in order to compensate for the risks involved. The IFM, by lending to such enterprises, provides a valuable social contribution in view of the fact that stimulation of small labour intensive enterprises is considered socially desirable but that no effective institutional credit delivery mechanism has been devised so far.

Cash borrowing from informal sources is also observed in all the sub-markets studied, though the magnitude of such credit is small compared to credit purchases. The principal sources of cash credit are friends and relatives, well-to-do businessmen, moneylenders and others. Collateral security is not needed for such loans. Most of the lenders are not professional moneylenders but have an established bond of trust with the borrowers and willingly lend to them. Interest is usually not charged by friends and relatives; trust and goodwill serve as the collateral in such transactions and an expected return flow of like favours in the future serve in lieu of interest.

Cash loans do often have stipulated rates of interest particularly when given out by moneylenders or businessmen. In many cases, loans do not have stipulated rates of interest, but financial benefits are seen to accrue to the creditors in various forms in lieu of interest. Thus cost of credit may be in terms of costly presents to the creditor on various social occasions.

made by the debtor in view of his obligated status. In the case of cash debt incurred by the entrepreneurs of the engineering workshops, such accruing financial benefits in the case of otherwise interest free loans may be in the form of:

i) free servicing facilities to the creditor,
ii) servicing of the creditors' orders at a discount rate,
iii) supply of machinery by the creditor at a marked-up price,
iv) temporary profit sharing arrangement, and
v) lump-sum return greater than principal.

Temporary profit-sharing arrangements are also noted in other sectors, such as in brickmaking where trusted friends and relatives often invest money against a safe return. Such arrangements are of course confined to parties that know each other well. Usually no deed of agreement is made; the whole business is conducted on the basis of mutual trust. The lender sometimes does not even know the modalities of the brick-making business; he only knows that he will get a better return on this investment than keeping money in a bank. Most such lenders are service holders with sufficient savings to invest.

The traditional moneylender is virtually non-existent in the urban IFM scenario. Even those identified by respondents as moneylenders are usually not so in the conventional sense of the term. Thus moneylenders referred to in the tanning industry are actually businessmen who lend surplus funds for short durations against stipulated rates of interest to close acquaintances only, at rates of interest varying from 64 to 96 per cent per annum. In the sphere of handloom, moneylenders are really mahajans (yarn traders) who normally engage only in credit sales of yarn but in certain cases respond to emergencies in their clients' situation (e.g. breakdown of a loom, adverse situation due to floods, a market depression, etc.) through the provision of cash loans. In these cases, mahajans have sufficient trust in their clients that the loan will be repaid but must charge an interest rate equal to the perceived opportunity cost of their funds (usually about 60 per cent).

While categorizing lenders as friends, relatives, neighbours, moneylenders, landlords, wealthy persons and so on, a knowledge of the background of these lenders is useful, since it would provide some clue as to the source of the funds. In the engineering workshop study, it was seen that friends, relatives and neighbours provide about 75 per cent of the cash credit from ICM sources, moneylenders 15 per cent and rich persons (who are not regular moneylenders) about 10 per cent. Service holders figure most prominently among these lenders (32 per cent of lenders). Amongst them, persons in government or semi-government services are the main contributors of informal credit. Some of these service holders are working abroad. Majority of service holders belong to the friends and relatives group, indicating that small bundles of personal savings of fixed income earners are being converted into industrial investments through informal sector intermediation. The second most important group of lenders (25.8 per cent) is associated with diverse kinds of trading activities. About 25.7 per cent of the lenders are involved in manufacturing activities, many of them operating engineering workshops themselves. Other important groups of creditors are people engaged in construction (6.5 per cent) and transport sector (6.5 per cent). Creditors drawn out of agriculture are the least important (3.2 per cent). It would appear that creditors are drawn out of diverse professions signifying a certain level of intersectoral mobility of capital.

VI MARKET SEGMENTATION

As seen in Section V, a major part of urban IFM operation relates to credit purchases of inputs, in which the transactors are actors in the same business or sector. Close business relationships between lenders and borrowers are the key to such credit operations. A yarn trader, for example, has yarn to sell on credit to a weaver, but has no credit to offer to a brickmaker. The extent of cash credit is limited and moreover confined to parties that know each other well --- friends, relatives and neighbours, for example. These lenders do not lend to just anyone who is willing to borrow at a given interest rate, however high; they will only lend to persons they trust and will normally not charge any interest. The role of the conventional moneylender is seen to be minimal in the urban informal market setting. Even those categorizrd as moneylenders are seen to be businessmen who lend surplus funds for short durations to people they know well, mahajans or traders who lend to their immediate clients, or landlords and other wealthy people who lend money to people in their area in order to enhance their political influence. It would appear, therefore, that the urban IFM is not an integrated market; there are instead a number of sub-markets segmented along various trading and production interests, along various patronages and lineages and along local political groupings.

In all the activities studied, it is observed that it is the close relationship between the transactors that sustain the credit operation. In the brick business, the buyers are brick traders; clearly their lending can only be to the brick-making business as such in order to sustain their business. An increase in rates of interest elsewhere in the economy would not lead these buyers to divert their funds there; consequently the market is segmented in this sense. In the leather business likewise, the credit flow down from wholesaler to retailer to producer can only be specific to that business alone. In the engineering workshop sector, it is seen that 23 per cent of the lenders are themselves engineering workshop owners, whereas 34 per cent are associated with the sector in one form or another. Out of this, 57 per cent are engineering sector-based or associated lenders and 36 per cent have direct production linkages with the debtors units. These close circuit operations have been found to be cemented by various types of socio-economic and political bondages. If we take into consideration the lenders who are relatives of the borrowers and those living in close proximity to the surveyed areas, the level of segmentation would be seen to be more pronounced. Approximately 69 per cent of the lenders have access to information relating to the sector in one form or another -- by virtue of their experience in running similar enterprises, by being associated in peripheral associated activities, by kinship relation and/or by living in locational proximity.

While the various urban submarkets for informal finance are segmented along their respective lines in the sense that interest rate changes in one sub-market would not affect interest rates in the other, it is not clear that segmentation in this sense exists between the organized financial sector and the urban IFM. If the central bank is pursuing a credit squeeze policy, the large wholesalers, who depend on institutional funds for a large part of their financing, would turn to the IFM for advances -- the excess demand spillover would then be reflected in higher interest rates in the respective informal sector submarkets. Moreover, the larger wholesalers would begin to charge higher interest on their credit sales and these higher interest rates would be transmitted down the line to retailers and eventual end-users. Consequently, the efficacy of monetary policy, though tempered by the existence of an IFM, is not nullified by it.

VII INTEREST RATE STRUCTURE AND THE EXISTENCE OF MONOPOLY PROFIT

The interest rate charged on credit offered by the IFM should reflect the opportunity cost of funds, risk premia and transactions costs; any excess would point to the existence of monopoly profits.

The high interest rates prevailing in the urban IFM can be explained by both demand and supply factors. Supply side factors are the shortage of capital and the riskiness of loans. On the demand side, low levels of income and household savings have made borrowers dependent on the IFM, and the low level of literacy and education has made it possible for the lenders to exploit the borrowers.

To find the opportunity cost of the informal loan fund, one can use as a proxy the highest rate offered by commercial banks on term deposits -- about 14.5% for a 3 year fixed deposit. If we asume that the investment income foregone by the creditors is twice that of the credit rate offered by the banks, the opportunity cost of loan funds would be about 29 per cent.

The possibility of default is trivial. The IFM actors know each other very well so that there are practically no defaulters; however, delays in repayments can and do occur, and impose some costs on the lender. All debtors in the IFM are in general eager to unburden themselves of their liabilities, and moreover, debtors do not believe that they would be able to get off without paying all their informal credit dues. Also delayed repayments or defaults would create a bad name for the debtor in a limited submarket; consequently his ability to obtain further inputs on credit would be seriously hampered. With the low default risks in the IFM, the risk premium element in the interest rate structure would appear to be small.

The cost of loan administration is minimal in informal market transactions (particularly in comparison to the nstitutional sector). Moreover, transactions costs are borne by the debtor and not by the creditor in IFM operations. Hence the nsactions cost is a variable of relevance for determining the al costs of borrowing and not for ascertaining the level and structure of interest rates.

Using the above arguments, it would appear that the stipulated interest rate less the opportunity cost of funds offered as credit would constitute a monopoly profit for the lender. In the engineering workshops sector for example, the average rate of interest for cash loans with stipulated interest rates is about 45 per cent. Since the opportunity cost of lenders funds is taken as 29 per cent, about 16 per cent may be considered as the monopoly profit appropriated by the creditor. Even if one makes some reasonable allowances for bad debts or riskiness of informal lending and for the costs incurred by the lenders for administering and collecting the loans, the share of monopoly profit in the structure of interest rate in the informal loan cases with stipulated interest rates would not be less than 10 per cent.

VIII USES OF FUNDS

The study of urban informal financial markets broadly shows that borrowed funds have been used for directly productive purposes by the borrowing enterprises. The reason is of course the preponderance of trade credit (input purchases on deferred payments basis) -- such inputs are purchased for productive uses. Rates of return for the particular enterprises have been sufficient to ensure timely credit repayments so that the next consignment of credit financed input can be procured by the entrepreneur.

The prevalence of cash credit has been relatively insignificant and has originated mostly from friends and relatives. While funds may have been borrowed for directly consumption purposes, the extent of it has not been investigated. It is clear, however, that in an urban setting, funds would not be borrowed from friends and relatives for non-productive purposes, except under emergency conditions. Cash borrowing for productive purposes, i.e. directly for use in the enterprise to meet short-term contingency needs, has however been resorted to. When such borrowing has been acquired from businessmen, mahajans, or other moneylenders, an interest rate of 50-70 per cent is usually charged. However, since the transactors are usually close acquaintances, the risk of default is minimal. The lender is aware that the funds are being used for productive purposes and would bear a high rate of return at the margin.

The study on overseas remittances has revealed that the returned migrants have given out about 5 per cent of their remittance money as loans mainly to friends, relatives and neighbours. While some of the loans have been used for a variety of consumption purposes, it appears that about 28 per cent of the loans have been used for commerical purposes and 41 per cent to finance out-migration. Migrants have, of course, an obvious repayment capacity, from the wages to be received abroad. Use of borrowed funds for purposes of migration is productive in the sense that the migrants would in the future remit funds much of which would be used productively.

The gold study and the study of the hundi system reveals the presence in the economy of a large pool of black money which is mostly used for unproductive purposes. The smuggling in of gold (estimated at about 75,000 tolas per year valued at about Tk 500 million) points to the existence of large flows of black money. The smuggled gold is used in the gold jewellery business (which though privately profitable, is socially non-productive), to finance illegal imports of various consumption goods, and a part is resmuggled out of the country. There is no evidence of procuctive use of the black liquidity generated, though many smugglers legitimize their operation through ownership of industries and commercial companies.

IX ROLE OF THE IFM IN SAVINGS MOBILIZATION

The IFM, by performing the same function of financial intermediation as the banks, could stimulate savings by offering lenders a higher return than they would realize through self-financed investment. They could also induce very small savers to save amounts that would otherwise have been spent on trivial consumption. While Roscas in Thailand, chit funds in India and arisans in Indonesia are important mobilizers of savings in the IFM, there is no evidence of the development of such organizational forms in urban Bangladesh.

The studies have revealed that most urban lenders lend out of their own funds and do not mobilize deposits. Consequently, they act so as to channelize savings towards more productive uses.

Evidences of savings mobilization through informal channels are observed in the case of informal employee credit schemes that have cropped up in many government set-ups, autonomous bodies and business organizations. Such schemes are actually informal arrangements through which contributing members seek, through a small regulatory monthly contribution, to create a mutual consolidated fund for the continued benefits of their exclusive members. Such savings and credit schemes form the basis on which contributing members can draw on the funds for a variety of purposes or given terms and conditions. Schemes of various sizes are seen to exist, from those with less than 10 members to some with more than 1000 members.

It is clear that such schemes have been successful in mobilizing deposits that would otherwise not have been saved at all but spent on trivial consumption. About 43 per cent of the funds are maintained in bank accounts (mostly in savings accounts), 2 per cent in other financial investments, 2 per cent in business ventures, 27 per cent is disbursed as loans to members, 15 per cent as grants to members or non-members, and 11 per cent in miscellaneous activities including entertainment expenses and administrative expenses. An overwhelming majority of the members (91 per cent) have taken loans to meet family emergencies. About 9 per cent of the members have taken short-term business and land loans. Rates of interest on loans are seen to vary from nil to 96 per cent per annum depending on the rules adopted by particular societies, the rate of interest reflecting the valuation that members place on the use of scarce funds.

The informal credit schemes, other than serving as small savings outlets and as bases for providing small loans to members to meet family contingencies, have been able to channelize a considerable amount of savings into the formal and organized credit market. There is no evidence as yet of any scheme that invests directly in high yielding but risky business ventures, as the organizers do not feel confident in the matter of risking group funds. Banks provide the safest outlet for investing the funds.

X DEVELOPING THE IFM

The widespread prevalence of the urban IFM relates to its ability to serve, quickly and efficiently, the needs of most of the enterprises and traders operating in the urban areas, and particularly the relatively small-scale operators who have practically no access to formal sources of finance. A close scrutiny of the pattern and terms of borrowing reveals that these entrepreneurs are predominantly in need of short-term, small size working capital loans. Given the intricacies involved in such types of loan operations, it is not possible for the institutional sector to offer services in this respect economically and efficiently. The administrative costs of providing small sized loans to a large number of small and cottage enterprises would be very high and not sustainable under the current institutional interest rate structure. Moreover, such entrepreneurs are unable to satisfy the banks' requirements of collateral, and most are intimidated by the paperwork involved. Consequently these enterprises have to compromise with the more stringent offers of the IFM. Their choice is not between borrowing from formal or informal sources, but between borrowing from informal sources or not at all. Given their sunk costs, the fact that their enterprise provides their prime source of livelihood, and that the productivity of capital at the margin is high enough to justify borrowing at typical IFM rates (70 to 100 per cent per annum), their choice is clear.

Informal financial markets have many advantages over formal financial institutions in the matter of credit delivery to small enterprises. The basic advantage is that each intermediary operates in his own particular sub-market, and has an intimate knowledge of his clients, which reduces information costs and minimizes default risks. Other advantages stem from the absence of government regulations on their operation. The absence of control on lending and borrowing rates governing the intermediaries enable them to adjust more fully to market forces than regulated intermediaries. Moreover the absence of charges on the informal intermediaries in the form of idle and low interest reserves gives them more flexibility than formal intermediaries. At times the advantage of the informal sector for the borrower is the rapidity with which it can provide money -- the borrower obtains the funds when they are most needed. By contrast, a common complaint of those entrepreneurs that have received bank financing is that the long period between loan application and final disbursement has often led them to borrow from the IFM long before the bank loan was disbursed in order to meet their immediate needs. As a consequence of all these, most of the small and cottage industries, much of the wholesale and export trade, and even many larger industrial firms on a sporadic basis, turn to the informal market for flexibility and accomodation in financing working capital that cannot be obtained from the commercial banks.

Given the current concern for expanding the role of small and medium labour-intensive industries, and the fact that shortage of working capital has been identified as a major constraint limiting the utilisation of capacity and reducing profitability of the enterprises, the need for providing easier credit to such enterprises assumes some measure of importance. As seen earlier, it is difficult to devise an institutional credit delivery mechanism that could effectively serve the needs of such clients. The IFM does the job effectively, but does not have the requisite funds to fully satisfy customer needs as is evidenced by the fact that most entrepreneurs complain of working capital shortages in spite of having full access to the IFM in terms of credit purchases and cash borrowing. The demand for credit may also be somewhat tempered due to the high interest rates prevalent in the IFM.

A solution to the problem would seen to hinge on the development of the IFM. One possible way would be to achieve some form of informal sector-formal sector interconnection, with the formal sector providing funds to the IFM for onlending to the target enterprises. Selected intermediaries in each submarket (e.g., wholesalers, large retailers) could be 'refinanced' by banks upto a certain proportion (say 50 per cent initially) of their credit sales of inputs to enterprises, a list of which the bank would maintain after careful scrutiny. The intermediaries would be wholly responsible for loan recovery and would make regular repayments to the banks within a stipulated period depending on the credit cycle. Loans for initial set-up and expansion of small enterprises (with longer repayment period) could also be made in this way. Alternatively, the bank could directly provide loans for expansion of enterprises that have demonstrated a good repayment record. The spread between the interest rate charged by the intermediaries and that charged by the bank would constitute the return for the intermediation. It can be expected that such an inflow of formal sector funds into the IFM would, by increasing the supply of funds, result in lower interest rates in the IFM than that observed at present. Moreover, competition among different intermediaries within the same sub-market could be expected to bid interest rates down to a certain extent. A pilot project based on this scheme could be initiated.

Another alternative would be to encourage the formation of savings and loan associations of the entrepreneurs within each sector. Such associations would obtain deposits from the members and invest the funds in financing the enterprises. Bank credit could be channelized to established institutions for onlending to the members.

These and other alternatives must be explored in order to ensure that the IFM becomes an effective partner of the formal sector in financial intermediation.

XI CONCLUSION

Three issues of paramount interest are those concerning the role of the urban IFM in (a) promoting domestic resource mobilization, (b) in channelizing resources into productive investment, i.e. in maximizing allocative efficiency, and (c) in promoting equity.

Regarding domestic resource mobilization, there is still insufficient information regarding the savings and consumption behaviour of the lenders, or how far they rely on formal financial institutions to onlend to the borrowers. The study has not found any evidence as to the existence of ICMs that accept deposits and mediate savings. However, a number of informal employee credit schemes are seen to exist in urban offices that are able to mop up savings from funds that would otherwise have been spent for trivial consumption and divert a considerable part of these savings into the formal and organized credit market.

The continued existence of ICMs tends to suggest that they are not inefficient allocators of resources. By cutting transactions costs and reducing risks through personalized contracts, IFMs are seen to be reaching those activities which are not being reached by the formal financial institutions. Within each activity again, IFMs are seen to reach the smaller enterprises who are completely bypassed by institutional lending sources. To the extent that the small and cottage industries have access to IFM and to the extent that they have higher productivity. IFMs serve both the growth and the equity objectives.

The impact of the IFM on the distribution of income and assets is also an issue of considerable interest. Some view the IFM as exploitative and leading to a transfer of assets from the poor borrowers to the rich lenders. However, this can only be true in a situation where the borrowers use the credit for unproductive purposes and are eventually forced to liquidate their meagre assets in order to repay the loan. In the urban setting, the IFM is seen to promote the equity objective. In all the activities studied, it has been observed that the low, administered interest rates of the formal financial institutions are available to only the larger establishments and traders who have sufficient collateral to offer and have the necessary connections. For the smaller establishments, the IFM is usually the only source of credit. In so far as the entrepreneurs of these smaller enterprises manage to squeeze out profits despite the relatively high costs of borrowing, there is a case for rationalization of the interest rate structure and for the devising of mechanisms whereby institutional lending may be made available to the small but efficient entrepreneurs. Channeling of bank credit directly to small enterprise groups and associations or indirectly to such small enterprises through some formal-informal sector interaction mechanism may provide a starting point.