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<u>KATAPILA</u> MONEYLENDERS AND INFORMAL FINANCIAL MARKETS IN MALAWI

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Abstract

After outlining the institutional financial services available to small and medium enterprises in Malawi, this paper surveys Malawi's informal financial markets (IFMs). A detailed report is then presented on the character and operations of a *katapila* moneylender in Lilongwe, Malawi, based on an extended interview. Information about the moneylender market is analyzed in terms of themes from the literature on IFMs in developing countries. One important finding is that the interest charges on *katapila* loans are not justified by economic costs of doing business. Finally, policy implications for promoting more efficient finance are addressed.

Katapila Moneylenders and Informal Financial Markets in Malawi

Bruce R. Bolnick*

1. Introduction

Informal financial markets (IFMs) have gained respectability. Not long ago moneylenders were regarded as parasites who exploited impoverished peasants. Today one reads more often about how informal lenders provide efficient financial services to a broad clientele that has been poorly served by formal-sector intermediaries (FIs). World Bank analysts formerly dealt with IFMs as part of the problem facing small enterprises (Kochav, et al., 1974); now they debate how informal markets can be nurtured as part of the solution (World Bank, 1989). Fueling this transformation of opinion has been a growing body of research[1] demonstrating that IFMs are less exploitative than formerly assumed, and indeed quite well suited to administering financial services in small doses. Research has also established that formal-sector loan programs for "priority" groups such as small and medium enterprises (SMEs) are often costly failures, even to the point of undermining the financial health of the institutions involved.[2]

Until very recently, research on IFMs largely bypassed Malawi. After a brief survey of formal and informal financial markets in Malawi, this paper provides a detailed portrait of an urban moneylender in Lilongwe. Moneylenders are usually highly secretive; indeed some influential papers have dealt with the subject on the basis of second-hand information.[3] In the present case, I was able to arrange a candid interview with a prominent katapila moneylender. Findings from the interview form the "empirical" core of the paper.

As background, section 2 outlines the network of formal and semi-formal FIs in Malawi, with a focus on services for SMEs. The literature the country's IFMs is surveyed in section 3. Section 4 contains a detailed account of the katapila moneylending business in Lilongwe. Section 5 analyzes this loan market in terms of some basic debates about the character of IFMs in developing countries. Among other things, I document that sizeable monopoly rents characterize the katapila loan market, suggesting a severe lack of competition in serving the financial needs of large segments of the economy. Section 6 discusses what can be done to supply more efficient and effective financial services to entrepreneurs outside the narrow modern sector in Malawi. Section 7 offers concluding remarks.

2. Financial Services for SMEs in Malawi

Although credit services command center stage in most discussions of financial markets, deposit services are at least as important. For many SMEs borrowing is imprudent, particularly if loans are priced to cover costs. Virtually all SMEs, however, can benefit from having access to convenient, safe, and remunerative deposit facilities for storing liquidity and accumulating capital.[4]

Formal-sector deposit and credit services for SMEs

For such a poor country Malawi has a fairly well developed infrastructure of deposit facilities serving economic centers where SMEs cluster. The most convenient deposit institution for most Malawians is the Post Office Savings Bank (POSB), which operates more than 250 savings windows throughout the country. The nation's two commercial banks have regular branches only in urban areas, but they operate agency offices in trading centers and send mobile units to roughly 100 rural "stopping points" at least once a fortnight. The mobile units only handle deposits, and not loans. The New Building Society (NBS) also provides deposit services in major urban areas. Finally, two leasing/hire-purchase companies offer term deposits bearing the most attractive interest rates in the country, but these companies are familiar only to a small clientele.

Given this deposit infrastructure, one might suppose that economic units with peak cash balances above some trivial threshhold would hold a deposit account. In fact, only a minority of Malawian SMEs patronizes these institutions.[5] One contributing factor may be that ex-post real deposit interest rates have been negative since 1983.[6] (Table 1 shows the structure of deposit rates as of mid-1989). Patronage of institutional depositories is also inhibited by transactions costs (including time and travel costs), minimum balance requirements, withholding tax (from which POSB accounts are exempt), withdrawal restrictions, and cultural factors such as a reluctance to record finances, or discomfort in dealing with formal institutions.[7] Another reason that SMEs and small savers may avoid formal deposit institutions is the absence of reciprocal access to loans. Vogel and Burkett (1986), among others, cite "reciprocity" as an important element in mobilizing savings.

With few exceptions the only formal-sector credit sources for SMEs are two specialized non-depository FIs: Indefund and SEDOM. Indefund, one of three development banks, specializes in serving medium-sized enterprises with loans ranging from $11,000 to $75,000 (using the 2.65 Kwacha/dollar exchange rate prevailing in July, 1989). Indefund, however, is a low-volume business. By mid-1989, after seven years of operation, the bank had approved a cumulative total of barely more than 100 loans.[8]

SEDOM, the Small Enterprise Development Organisation of Malawi, extends a larger volume of credit to SMEs. Established in 1982, SEDOM offers commercial mini-loans ranging from roughly $40 to $1900, and term loans as large as $28,000, along with management advice and procurement assistance. The interest rate is 18%. At the end of 1988, SEDOM had 2300 loans outstanding, averaging K4,100 ($1,500) (Beza, 1988). Because it faces a small average loan size, a large burden of non-financial support for SME clients, and a troublesome arrears problem, SEDOM has little chance of becoming self-supporting without major restructuring. Also, not being a bank, the organization cannot accept deposits.

In summary, formal-sector deposit services are widely accessible, but not well patronized by SMEs. On the other side of the ledger only one specialized (and subsidized) institution, SEDOM, generates a sizeable volume of SME credit. The bottom line is that well established small-scale entrepreneurs with legitimate and productive credit needs--the tinsmith who could buy tin sheets in larger lots to reduce the cost of frequent trips to the supplier; the tailor who could buy bolts of cloth to prepare an inventory of ready-made clothes for the harvest-season market; the rural trader who could profit from acquiring a small pick-up truck or a bicycle--typically have no access to formal-sector loans.

Semi-formal institutions

As used here the term "semi-formal" refers to grass-roots financial networks supported by a formal institutional structure. In Malawi, three organizations fit this description: the MUSCCO credit union system, the National Rural Development Program (NRDP) program under the Ministry of Agriculture, and the nascent Mudzi Fund.

MUSCCO[9] is the national umbrella organization for an expanding system of local credit union (CUs). MUSCCO operations include assisting rural and urban groups to organize CUs; training CU managers (who usually serve without pay); providing small seed-capital loans to new CUs; monitoring CU finances and operations; and extending loans through well functioning CUs to supplement their lending capacity.

Individuals who join a CU build up credit ratings step by step, beginning (after six months) with short-term loans against their share-deposit balances. This has been called a "rachet" loan system (World Bank, 1979). Most loans bear an interest rate of 18%. Casual monitoring by MUSCCO officials suggests that loans are used primarily for productive purposes, most often for buying fertilizer. As of mid-1989 the CU system had 18,000 members with an average deposit balance of K155 (nearly $60) per member. Although the interest rate on CU share deposits is only 5% (plus dividends, which are rare), these deposits qualify members for loans and for life insurance,[10] each of which may have a very high shadow value for poor, liquidity-constrained Malawians.

In evaluating MUSCCO, two points stand out. First, CU membership is still miniscule compared to the potential market for financial services,[11] yet the system cannot grow hastily if prudential standards are to be maintained. Moreover, the staying power of local CU groups has yet to be demonstrated in Malawi. Second, there is no realistic prospect that the MUSCCO organization will be self-supporting for years to come.

The second source of semi-formal credit, the NRDP, provides in-kind loans through "farmer's clubs." These loans reach both farm and non-farm enterprises through fungibility effects, since farmers who receive NRDP loans can reallocate their own cash to non-farm activities. Early farmer's club loan programs in Malawi were acclaimed as successes (Schefer-Kehnert, 1980). More recently, though, NRDP loans have been criticized severely for reaching only the top echelon of villagers, for heavy-handed foreclosure practices, and for inflexibility of the farm input package. Program participation has declined sharply from a peak of perhaps 16% of small-holder households.

A third semi-formal financial institution, the Mudzi Fund ("Village Fund"), is just moving from the drawing board to pilot testing. Modeled after the Grameen Bank in Bangladesh, Mudzi Fund field staff in the villages will help very poor farmers organize savings and credit groups of five people each. Details have yet to be finalized, and it will be years before the program can be replicated widely. Also, like MUSCCO (and SEDOM), the Mudzi Fund will depend on a donor lifeline for many years to come.

Overall, semi-formal FIs have begun penetrating the countryside with deposit and loan services that are packaged appropriately for SMEs and low-income households. Nonetheless, formal and semi-formal FIs taken together fall far short of satisfying the effective demand for financial services in Malawi. In view of evidence from countries like Korea and India, or Nigeria and Sierra Leone in Africa,[12] the obvious question to ask is whether informal markets satisfy the enormous residual demands.

3. Informal Financial Markets

This section briefly outlines traditional debt relationships as described by pre-independence anthropologists and historians, and then surveys more contemporary accounts of IFMs in Malawi.

Traditional debt relationships

In perhaps the most thorough account of traditional debt in Malawi, van Velsen (1964) describes how among the lakeshore Tonga people half the bridewealth payments took the form of a promissory note (kalata) that was legally enforceable under traditional law. Typically this debt remained outstanding throughout the duration of a marriage, creating a social bond that strengthened links between families of the bride and groom. The debt could be forgiven if the marriage proved to be a long and happy one.

Van Velsen remarks (p. 125) that bridewealth debt was only one example of "the countless number of debt relationships between individuals and small groups." Like kalata, many debt claims remained dormant for long periods of time. Cash debts--often to finance trips to jobs in towns or in neighboring territories--bore a flat interest charge of 100%, with no fixed maturity. Exactly the same terms for cash debt are cited in Rangeley's (1948) discussion of tribal law among the Chewa. Rangeley adds that the ambiguous maturity led frequently to litigation in tribal courts.

Cash came into use in Nyasaland only in the 1890s, so tradition debts were extended and repaid in kind. Rangeley states that on such debts (ngongole) no interest was paid except in special cases. In contrast, Chimango (1977) reports that loans of millet for brewing beer were traditional repaid double. He notes, though, that the "interest" charge was strictly a moral obligation associated with proper cultural behavior. Only the debt principal was enforceable in traditional courts.

Chimango also gives a detailed description of katapila (or chimbazo) loans. Traditionally, the term referred specifically to loans co-signed by a third party called the mboni, or witness. The usual interest charge was 100%, while maturity was subject to negotiation. These katapila loans, including the mboni's obligation, were enforceable under tribal law. Chimango mentions in passing (p. 83) "the problem of chronic indebtedness resulting from usury in the villages."

These references indicate that debt relationships were pervasive in traditional Malawian society. Only a single reference to deposit services could be found. Murray (1932, p. 293) noted that "both Government and principal missions provide savings bank facilities for natives." It is difficult to imagine that such facilities were much used. Other sources suggest that Malawians routinely hoard cash and often bury it, to the present day.

Contemporary reports

If historical accounts are spotty, contemporary research on informal finance is also far from complete. An early sample survey of rural industry and commerce in Malawi by Wood and Robinson (1963) revealed that virtually only 5% of African businesses were able to buy on credit (on 30-day terms) from suppliers. All others had to pay cash. On the opposite side of the ledger, small businesses often extended credit to final consumers at zero interest. Field interviews conducted by the author indicated that the same financial squeeze remains a fact of life for most Malawian SMEs in 1989.[13]

In a similar vein, a 1986 sample survey of more than 1300 non-agricultural SMEs (READI, 1987) found self-finance to be the predominant source of funds for both start-ups and expansions. Fully 85% of respondents started out with no external finance, even from relatives and friends. Of those reporting expansion (52%) only 3% used outside finance for this purpose. Nearly 70% of all respondents identified lack of finance as the single major constraint facing their business.

Both the early Wood-Robinson report and the READI study suggest that SMEs use very little informal finance. Chipeta and Mkandawire (1989), however, record a large volume of informal finance flowing through a variety of channels. Their paper presents a preliminary analysis of a sample survey of 1611 households. Extrapolating from survey data, Chipeta and Mkandawire (henceforth C-M) calculate that informal credit in Malawi totaled roughly K250 million in 1988. For comparison, the IMF <u>International Financial Statistics Yearbook</u> (1989) reports that claims on the private sector by deposit money banks plus other banking institutions totaled K288 in 1988. Common forms of informal finance include loans from employers, landlords, friends, relatives. Most are short-term transactions at zero or near-zero nominal interest rates. Survey responses indicate that informal loans often finance business spending, including farm fertilizer purchases. Notably missing from the C-M survey is information on suppliers credit.

To reconcile the C-M household survey with other evidence on SME finance one may conclude--pending better information--that informal loans commonly supply working capital for SMEs, but a large residual demand for working capital remains, and investment finance is virtually absent.

The C-M study also provides clarification about the status of rotating savings and credit associations (ROSCAs) in Malawi. One previous study (Reeser et al., 1989) contended that ROSCAs are not typically found in Malawi. Another (Miracle et al., 1980) cited the widespread presence of small ROSCA groups called chilemba, or chilvelano, or katapila. As explained by C-M, the first two terms (as well as chiperegani) are traditional forms of cooperative consumption entailing reciprocal obligations, but not lending or borrowing per se. The practice has evolved, however, into cash arrangements that amount to ad hoc ROSCAs, typically with two partners and very short duration. As seen above, the term katapila refers to moneylending. In this regard, the C-M survey found a growing number of (apparently non-rotating) savings and credit associations (SCAs), some of which generate income through lending to non-members on katapila-like terms.

Besides SCA loans made to non-members, the only significant source of arms-length informal credit found by C-M was from katapila moneylenders, including farmers, salaried employees, and businessmen. Very few depended entirely on moneylending for their income, though one-fourth devoted at least half-time to these activities. The distribution of interest charges was bi-modal, with typical charges of 50% or 100% over the life of a loan (most often one month). Note that these are charges, not annualized rates of interest. Based on their interview data, C-M estimate total katapila lending at K9.6 million, or 3% of estimated total informal finance in Malawi.

In summary, one can read the available evidence as showing that informal finance is thriving in Malawi. On second glance, though, signs point to a striking paucity of IFM services for SMEs. Stable, organized ROSCAs are uncommon. Access to supplier credits is exceptional. Many informal institutions found in other LDCs--such as market banks, deposit collectors, money guards, finance companies, or pawnshops--are absent altogether. Moneylenders there are, but evidence suggests that they finance exigencies far more than directly productive activities.

Financial transactions among close associates are commonplace, yet only a small volume of finance flows through what might be considered an informal market. While clearly Pareto-superior to no finance at all, transient small-group transactions are poor substitutes for markets. Such narrow-scope finance is second only to pure self-finance in creating fragmented saving flows and concomitant marginal product divergences. Such finance also entails a minimum degree of competition among lenders. And with zero (or near-zero) nominal interest rates being charged, it does nothing to screen out low-productivity uses of funds. Although numerous SMEs may find ways to top up self-finance with short-term loans from primary contacts, most have little ultimate recourse to financial services from either formal or informal markets.

I turn now to filling in some details about one of the few sources of arms-length credit in the network of IFMs: <u>katapila</u> loans.

4. Portrait of a <u>Katapila</u> Moneylender

<u>Making Contact</u>

This section reports on an extended interview with a full-time <u>katapila</u> moneylender in Lilongwe, Mr. Ch_____. The interview was arranged by our study team's driver, Yusuf Kandango, who happened to have patronized the moneylender on more than one occasion through a colleague at work. Because the man's reputation was well known, Yusuf presumed that he operated openly and had no cause for secrecy. This presumption proved incorrect. When we entered his small, three-room, cement-block home on the outskirts of the city, Mr. Ch_____ became visibly angered and distressed. Both Yusuf and I were interrogated heatedly, in an atmosphere of considerable tension. Initially the moneylender refused to provide any information: he was a private businessman whose activities were of no concern to anyone else. Gradually, though, his anger subsided. Mr. Ch_____ settled into his old, soft chair, placed his bare, calloused feet on the coffee table, and began talking about his business.

<u>The katapila moneylender and his business</u>.

The moneylender's "office" was his living room, which was just large enough for an old couch, two chairs, an old coffee table, and a wooden cabinet with a lock. One bare light bulb hung from the ceiling. His clothing, like the house, lacked any sign of ostentation. Mr. Ch_____ started moneylending on a part-time basis in Zomba, where he worked for forty years as a cook for a prominent Englishman. After retiring in 1973 with a gratuity of K1000 he moved to Lilongwe and began lending money professionally. Mr. Ch_____ lends only his own funds. Even without leverage, he has accumulated enough wealth to own three houses outright (including his residence), in addition to holding a large portfolio of loans and a deposit account of unstated size at the NBS.

Mr. Ch_____ was reviewing his accounts when I arrived. He hastily locked the records away in a plain wooden cabinet, but later took them out to show me the extent of his business. Literally hundreds of accounts were updated regularly in very neat handwriting on ordinary lined paper. The loans ranged in size from K14 to K2500. Most were on the order of K50-400, with the median falling roughly in the middle of this range. Even though Mr. Ch_____ is out doing business from 6 AM to 6 PM each day, his loan volume reflects the fact that he operates through a network of agents located throughout the city. These agents are old and trusted customers. Mr. Ch_____ claims to have agents in workshops, markets, and offices all around the city--including banks and ministries. That very day he had issued a K2500 loan to a foreign embassy employee who had been referred by an agent. He proudly displayed a letter, typed in English and stamped with the embassy seal, confirming the man's employment. In a second letter, typed in Chichewa, the borrower acknowledged the debt and promised to repay K3500 with the provision that "if I do not repay in one month Mr. Ch_____ will get my house" (Yusuf's translation).

Other than its unusual size, this particular loan illustrates standard features of the moneylender's business. First, the loan bears an interest charge of 40% (borrow K2500, repay K3500), falling due in one month. The interest charge does not compound if payment is overdue. These terms would yield a gross return in excess of 5000% per annum with timely repayments and prompt turnover. Apart from occasional interest-free loans as favors to regular customers, the same 40% charge applies to all direct loans, large or small. Loans issued through agents bear a 50% charge, with the additional 10% accruing to the agent.[14] Even an impoverished mother who needed money to buy medicine for a sick child would pay the same charge. "After all," said Mr. Ch_____, "this is my business. No one expects me to give money away." Besides, he added, "we do not charge much." Compared to the traditional 100% charge on <u>katapila</u> loans (Chimango, 1977), the price of funds is superficially moderate; then again, on traditional loans the maturity was not fixed at one month.

When necessary Mr. Ch_____ adjusts the repayment schedule to fit a borrower's income stream. For example, a man earning only K30 per month might be allowed to borrow K40 on the condition that he repay K56 (still a gross 40% markup) in four installments of K14 each. Such installment agreements, however, are exceptional. One month is the standard.

The embassy employee's debt is typical of large <u>katapila</u> loans in that it is based on a formal written agreement, and secured with specific collateral. When issued through an agent, such loan papers are cosigned by the intermediary. Even though the moneylender's business is unlicensed, these "contracts" (as he called them) are fully enforceable in traditional court, which operates in Malawi as a parallel system of justice. A borrower failing to repay on time is visited by the moneylender and encouraged to work out the loan.[15] Then he is sued, if necessary. The court usually binds the debtor to a repayment schedule. Wages are sometimes attached. Refusal to abide by a court decision can result in contempt charges that can be punishable by fines, confiscation of property, or jail. For the moneylender the legal procedure is simple, inexpensive, quick, and effective.

Loan contracts can also be collected through other channels. Mr. Ch_____ told of one instance where a school teacher borrowed K400 and was killed in an automobile accident the same night. The man's father honored the debt in full, though he had not cosigned the agreement. In other cases outstanding debts were paid by the borrower's brothers.[16] Also, the mboni who cosigns a katapila loan is ultimately responsible for repayment.

This effective enforcement system minimizes bad debt risks, but does not eliminate risk costs entirely. Tardy repayments still cost the lender the time required for dunning and for court appearances. When liquidity happens to a binding constraint on business, the lthat could have been earned by turning funds over in new loans. In addition, a favorable court decision is not certain (Chimango, 1977). On occasion the court upholds repayment of principal only. As Mr. Ch_____ explained, "some we lose, some we win." He gave the distinct impression, however, that winning was far and away the more familiar outcome. The lender faces an associated risk of recalcitrant debtors filing complaints with the police, including charges of misdeeds. Ironically, such complications are more likely on loans to affluent and sophisticated debtors than on loans to poorer, more traditional customers.

By no means all borrowers are office workers with bank accounts and homes to be attached. Many small loans go to poor families, workers, and small entrepreneurs. Mr. C_____'s commercial customers included shopkeepers, garment makers, fishsellers, grocers, and vendors. Loans are used for buying food and clothing, for medical care, funerals, and trips, and for financing working capital. When asked how a shopkeeper could turn a profit when borrowing at 40% interest, Mr. Ch_____ replied that it was not his business to know such things.

Although the moneylender deals with all types of customers, he does exercise selectivity. One task of his agents is to screen out unreliable customers and to vouch for those who get loans. Mr. Ch_____ turns down requests from individuals who have not repaid previous loans promptly, or who are known to be wasteful. If nothing is known about an applicant, the lending decision is delayed for a day to allow an informal investigation to be conducted through a network that includes three other prominent katapila moneylenders in the city. (Mr. Ch_____ acknowledged being one of four "big men" in the business in Lilongwe.)

Still, it is interesting to find that the moneylender does not have an intimate direct knowledge of his customers, as commonly asserted in the literature on informal lending. Mr. Ch_____ admitted that he is often unable to judge who is good and who is bad, in part because a person's behavior can change. A good customer in the past may now have more children to feed, or business problems, or new obligations to the extended family. It is difficult, he said, to trust anyone. Still, he affirmed confidently that his information was better than that to which a banker would have access.

In view of his age and affluence, I inquired about why he continued working each day from dawn until dusk, rather than relaxing and enjoying his wealth. His long response boiled down to a simple desire to accumulate wealth. When asked whether he perceived himself as providing a service to his clients, Mr. Ch_____ paused, as if never having given this a thought, and responded with a wide grin: "I help them, and they help me." His emphasis was decidedly on the latter half of the declaration.

5. Implications for the Economic Analysis of IFMs

This section assesses the katapila loan market in light of some on-going controversies and stylized facts about IFMs in developing countries. Until better information becomes available the analysis is necessarily tentative.

One major point of contention in the literature concerns the justification for interest rates on IFM loans. Many observers explain high interest rates in terms of the economic costs of lending to very small borrowers, including administrative costs, risk costs, and the opportunity cost of funds (Long, 1968; Bottomley 1975). In effect, lending rates are regarded as market-driven efficiency prices, given the information and enforcement constraints characterizing IFMs. A dissenting minority, following Bhaduri (1977), still views moneylender interest rates as monopolistic and exploitative.

The facts available here do not support a precise computation of Mr. Ch_____'s business costs, but an illustrative calculation suggests that his interest charges are far too high to be efficiency prices. The methodology used here is to fill in data gaps with assumptions that exaggerate costs and understate revenues, and then to show that even under these favorable assumptions the efficiency-price hypothesis can be rejected.

Consider a lender holding a stable volume of 300 outstanding loans,[17] with an average principle of K200, due in one month with an interest charge of 40%. For lack of a hard figure on payment delays, assume that the average loan actually takes two months to collect, so 1800 loans turn over each year. Suppose further that the moneylender suffers a complete loss of interest plus principal on 5% of each round of loans. These assumptions imply that the katapila lender's gross revenue every two months is 40%x(1-.05)xK60,000 = K22,800. Even without compounding the return, gross annual revenue totals K136,800.

Against this revenue the lender's economic costs must be deducted. The assumed 5% bad debt rate means a loss of principal totaling K18,000 per year (K3,000 every two months). Suppose that the lender's time--including time spent on issuing new loans, managing active accounts, collecting maturing debts, and pursuing overdue payments--is valued at K20,000 per year (an extremely high salary in Malawi). Administrative costs are miniscule, say K1000 per year.

On these assumptions the annual cost of doing business (excluding the opportunity cost of capital) totals K39,000, leaving a net profit of K97,800. The corresponding rate of return on capital equals 163% per annum.[18] As long as the opportunity cost of capital is lower than 163% the moneylender earns economic profits. In point of fact, Mr. Ch_____ holds his liquid asset inventory in a savings account at the New Building Society, which pays a nominal interest rate of 10.75% p.a., less 10% withhold tax. The inflation rate (26% and falling over the 12 months to July 1989) provides an approximate rate of return on the alternative of holding liquidity in the form of real goods. Even using double the inflation rate as the opportunity cost of funds, the moneylender earns economic profits in excess of 100% per annum.

Only a fraction of gross income, therefore, is justified by the economic costs of doing business, even on assumptions that deliberately exaggerate costs and understate revenues. Either the <u>katapila</u> lender earns huge monopoly rents, or he faces large hidden costs or uncertainty premia. On the latter, there is no indication that bribery payments are an important charge (and even if they were, they would be rent transfers rather than economic costs of doing business).

A potential source of monopoly profits is not difficult to discern: if indeed four "big man" <u>katapila</u> lenders dominate the market in Lilongwe, setting similar terms and sharing information about debtors, the market structure is highly non-competitive. This hypothesis is supported by the fact that Mr. Ch_____'s interest charges have been invariant for many years despite large variations in the rate of inflation, the health of the economy, and the availability of bank credit to the private sector. The price of <u>katapila</u> loans has not responded to changes in supply and demand to clear the residual market, in a manner described by Roemer (1988) among others.

The puzzle, then, is to explain why this market has not yet become more competitive, driving the price down to the economic cost of supplying credit. There are no obvious scale economies or economic barriers to entry, and it is implausible that only a handful of people have any spare liquidity to lend. Even a small stock of seed capital would mushroom quickly at prevailing rates of return. In addition, there is no indication that official repression or licensing restrictions has blocked entry. Indeed, Chipeta and Mkandawire (1989) report that the number of lenders in the market (at least part-time) has grown rapidly during the past decade, including savings and credit associations which lend on katapila terms. Judging from the stickiness of loan prices, however, the growth supply has not outpaced demand.

A common tale told in the literature is that monopoly power arises because lending is confined to highly localized social spheres, due to the lender's need for intimate knowledge of borrowers, for social leverage in lieu of collateral, or for opportunities to recover debt through interlinked contracts. In Malawi, however, this tale has little relevance because informal debt contracts are legally enforceable. Urban moneylenders need not and do not restrict lending to a narrow ring of clients with whom they have long-standing direct contacts.

In other ways, though, social relationships may help explain the lack of competition in the katapila loan market. At work may reputation effects and cultural attitudes regarding debt, including shame and stigma attached to both borrowing and pursuing borrowers. Suppose these attitudes are in fact prevalent. Then (i) borrowers will pay a premium to deal with an established lender with a reputation for confidentiality; (ii) borrowers will pay a premium to avoid an embarrassing searching for bargain terms; (iii) most people with liquitd capital will forego a higher return to avoid the stigma of having to pursue debtors; and (iv) lacking a reputation for pursuing debtors, new lenders would encounter higher default rates than established lenders. Allegiency reinforces the last point: an established lender is more likely to be repaid because borrowers can be more confident that "he will be there when I need him again." In short, the monopoly profits may reflect social scarcity rents that newcomers will not readily undercut.[19]

While intriguing, this cultural explanation is not fully satisfying because similar stigmas are present in other countries where informal financial markets are far more active than those in Malawi. Whatever their actual cause, the high interest rates on katapila loans clearly cannot be explained by actual or expected bad debt costs. Bad debt risk is simply not a major problem in this market. What Bhaduri (1977) called "borrower's risk" is more evident than lender's risk. In Bhaduri's analysis lenders gain and borrowers lose from default because of exess collateral. In Malawi, however, borrower's risk stems simply from the fact that high-interest contracts are fully enforceable. Excessive collateral is not a standard feature of katapila contracts (the large embassy employee loan being an exception). Also, such collateral may be overturned in traditional court. Under these circumstances lenders do not encourage default, which imposes time costs and reduces the return on capital.

The katapila loan market also differs from the prototype moneylender market in that it is not splintered among highly localized groups. Nevertheless the market is segmented in important respects. Lenders do not mobilize funds from the community, so there occurs no intermediation of savings in general. Furthermore, there is little or no intermediation of funds between market areas (e.g., between Lilongwe and Blantyre).

It is notable, too, that screening and rationing are found in the katapila loan market. Mr. Ch_____ does not stand ready to satisfy the demand for credit at the market price. Rather, he denies loans to applicants who are regarded as substandard in terms of character or credit history. The presence of unsatisfied demand market cannot be due to having the interest rate set below equilibrium. If anything the interest rate is well above the supply price of credit, and liquid reserves are held at the same time that as borrowers are turned away. Such credit rationing is normally explained in terms of asymmetric information and adverse selection (Stiglitz and Weiss, 1981). To Mr. Ch_____, the cost of lending to sub-standard borrowers is not so much the expected loss of principal, but rather the decline in yield when repayments are delayed (since interest charges are not compounded).[20] During periods when liquidity is not a binding constraint lending (i.e., when deposit reserves are available), tardy repayments do not even cause loss of turnover. Even so the moneylender faces a _time_ constraint; hence pursuing debtors displaces the development of new business. The prospect of lost yield and lost time are incentives for reject loan requests that fail to satisfy a threshhold condition involving the likelihood of trouble-free repayment.

One further characteristic of the _katapila_ market warrants particular attention: loans to entrepreneurs. In the literature on IFMs, small enterprises are said to prefer borrowing from moneylenders because such loans can be arranged promptly, involve low transactions costs, and bear no restrictions on the use of funds. These attributes apply fully to the _katapila_ market in Malawi. Yet it remains to be demonstrated that SMEs can finance productive investments using short-term loans at extremely high interest charges.[21] It is true that when small businesses borrow they must expect a return in excess of the cost of funds. At the same time it would be astonishing to find investments yielding a return of more than 40% per month in the normal course of business, given that most SMEs operate in intensely competitive industries. (At such profit rates small businesses would not be small for long.) Lacking direct evidence, small business patronage of the _katapila_ market is understandable only as a response to severe and temporary liquidity constraints, or unusual and fleeting opportunities.

Even though we lack a good understanding of why SMEs borrow on very unfavorable terms, it is quite clear that a profitable market exists for loans bearing interest rates far higher than those currently charged by formal and semi-formal institutions in Malawi. Robust activity and high monopoly rents in the urban katapila loan market also imply that moneylenders face insufficient competition from alternative agents, be they formal or informal. Thus, pending future research to the contrary, Malawi's IFMs appear to be highly underdeveloped in terms of mobilizing savings and allocating funds to productive investments.[22]

6. Discussion: Implications for Policy

Competitive, efficient, and well-integrated financial markets yield important gains to savers, investors, and the economy at large. The obverse holds, too: in the absence of such markets, potential gains in welfare, efficiency and growth remain unrealized. The vast majority of microenterprises and SMEs in Malawi appear to have very limited access to external finance, and face an added handicap in that appropriate deposit services are unavailable for storing liquidity or accumulating savings. A broad and vital set of markets is missing. But what is the policy significance of this observation? Can anything be done to develop more effective deposit and loan services for small savers and small borrowers? One answer is that transactions costs are prohibitive. Experience in many other countries, however, demonstrates that small enterprises and low-income households can be much better served through either informal markets or through innovative formal-sector programs.[23] The follow-up question, then, is how can policy promote this objective?

Promoting More Efficient IFMs.

If the depiction in this paper of IFMs in Malawi is at all accurate, there exists considerable scope for deepening and diversifying these markets. In the market for katapila loans, for instance, added competition could move the market to an equilibrium where credit is less expensive and more readily available. There is also a need to expand the use of supplier credits, and for introducing a range of new and appropriate services including pawnshops, market banks, and deposit gathers.

One lesson of experience in other countries is that informal financial markets tend to expand in response to repression of the formal market, but this is not a constructive basis for policy. A more positive policy proposal for promoting informal markets is to eliminate government restrictions that hinder their growth. In Malawi, however, overt restrictions have not been a major factor explaining the embryonic state of the IFMs.

Given the inherently bureacratic nature of government programs it is tempting to conclude that government can do nothing to foster informal markets beyond establishing a facilitating legal environment and then standing aside. A clumsy elephant can't be asked to knit even if there is a demand for shawls. I contend, however, that government can pursue limited, indirect actions to help nurture IFM development. As an example, municipal authorities, who regulate local markets, might be instrumental in establishing local market banks. Or the Ministry of Trade, Industry and Tourism and the Chamber of Commerce might cooperate in organizing workshops to address the barriers that inhibit more widespread use of supplier credits (including the sensitive issue of communal distrust). At a miminum the government can encourage informal financial markets by broadcasting information to potential financial entrepreneurs about the legal environment, business opportunities, and techniques for establishing informal saving and credit associations. These are all low-cost options that can be pursued without introducing the heavy hand of bureaucracy into the informal market mechanism. Even such limited efforts to intensify competition and diversify IFMs will pay off if they help to promote more affordable and better integrated flows of informal finance for SMEs and low-income households.

Linking Informal and Formal Markets

An intriguing concept that has been on the table for discussion at least since 1973[24] is to service small borrowers and savers by linking formal and informal financial markets. One proposal is for commercial banks to use informal lenders as agents, to take advantage of their low transactions costs, great flexibility, ready availability to borrowers, astute knowledge of local conditions, and recourse to social sanctions. Alternatively, the arrangement may simply involve providing financial leverage and secure deposit facilities for informal groups or agents.

In many contexts formal-informal links appear spontaneously. Long before government credit programs were introduced in India, for example, a large volume of bank funds was being channeled to SMEs in Bombay through informal intermediaries (Timberg 1979). Seibel (1988) reports finding links between informal deposit collectors and banks in West Africa. In many countries loans from suppliers are routinely financed (indirectly, at least) with bank loans or overdrafts. Even Mr. Ch_____, the katapila moneylender, maintains an account at the New Building Society for holding liquidity.

It is hard to find successful policy measures to this end, however. A major effort in India in 1972 floundered when the Reserve Bank and traditional indigenous bankers could not reach an agreement on terms for channeling loan funds (Timberg 1979, p. 20). The World Development Report 1989 (p. 119) recommends "building upon, not supplanting, the existing arrangements" found in LDCs, but the few examples cited therein entail little more than upgrading ongoing savings and credit groups. Perhaps it is best to let links develop of their own accord, while directing scarce policy capacity to other programs for deepening financial markets.

Cost-effective Institutional Financial Services for SMEs

Efforts are underway in Malawi to develop credit unions, to improve the effectiveness of farmers-club loans, and to establish the Mudzi Fund as a bank for the rural poor. Programs are also in place to support non-bank FIs such as SEDOM that specialize in SME loans. With the possible exception of the farmers-club loans, these programs are nowhere near achieving either broad penetration of the market or self-supporting operation. In contrast, the POSB and the commercial banks have both a physical presence that spans the country and a demonstrated capacity to stand on their own financial feet. Innovative financial technologies might enable these institutions to serve the latent SME market effectively and profitably.[25] Introducing formal-sector competition into this markets would also erode the monopoly power of the moneylenders, thereby reducing the cost and augmenting the supply of credit throughout the economy.

Financial market interventions have earned a world-wide reputation for counter-productive effects. Yet many analysts acknowledge the value of what Cho and Khatkhate (1989) call "market-promoting" interventions in countries where financial markets are poorly developed and non-competitive. Measured interventions can help stimulate the innovations needed to service SMEs. For Malawi, one basic innovation would be simply to license new banks, to break up the present duopoly. Beyond this, <u>temporary</u> subsidies and technical assistance are needed to support pilot testing of innovative bank programs and to underwrite the unavoidable costs of learning and adjustment.

It is beyond the scope of this paper to examine in detail the possible innovations, but a few examples can be suggested. Commercial banks might test-market "high" interest rate loans to non-traditional clients, to explore risk-return trade-offs in this market. They might experiment with "ratcheted" loans to small customers, where savers initially qualify for loans against deposit balances and then gradually work up to larger loans--emulating procedures used by the credit unions. Banks might also try upgrading rural units into profit centers offering ratchet loans with highly simplified procedures, including use of a local mboni witness as character reference in lieu of collateral. With the addition of loan functions rural units could generate direct revenues and (by offering reciprocity) attract more deposits. Similarly, the POSB might be restructured as a savings and loan organization, issuing small ratchet loans based on a minimum of paperwork. Also, lending programs tied to government procurement can be developed, using escrow accounts to assure timely release of government payments to SME suppliers.[26]

Among others, Ashe and Cosbett (1989), Christen (1989), Pulley (1989), and Snodgrass and Patten (1989) provide insightful guidelines about how to make such programs work. One critical factor is that interest rates must at least cover the variable costs of operation. This requires a higher lending rate on small credits than on standard loans. For a loan program to penetrate the SME market it is essential, too, for procedures to be extremely simple, with repayment being motivated by the structure of the program rather than requiring costly supervision or heavy collateral. One design concept that has worked well in Indonesia is to levy an interest rate surcharge that is returned to the borrower upon satisfactory repayment. Regulatory and legal changes may be needed, as well.

Government-directed forced lending is neither necessary nor constructive. Policy efforts to engage formal-sector FIs in experiments to service the SME market are vastly more difficult if the FIs are reluctant partners. Lack of a commitment by top bank management can be a huge stumbling block to successful, cost-effective innovation. Moreover nothing is to gained in the long run by having bureaucrats usurp responsibilities of the bankers.

7. Conclusions.

Given the huge gaps that exist in the network of institutional finance in Malawi, one would expect informal financial markets (IFMs) to be thriving. By all appearances, though, Malawi's IFMs are themselves quite rudimentary. Short-term, zero-interest loans among friends, associates, and relatives are common, but many informal financial services found in other LDCs are either underdeveloped or absent. Overall, small enterprises in Malawi operate in a world not too far removed from pure self finance. More field study is certainly needed, however, to provide a more accurate picture of the status of IFMs and SME finance in Malawi, and their evolution as the economy develops.

Malawi's <u>katapila</u> moneylenders, the main focus of this paper, appear to be quite different from informal financiers described in other countries. They charge interest rates far higher than the economic costs of doing business, yet their contracts are enforceable in traditional court. They earn large monopoly rents, even though the market has no overt entry restrictions, and close social ties with borrowers are not a prerequisite for lending. Overall, the evidence indicates a great need for increased competition and diversity in the informal financial markets.

The role of government in this process is necessarily limited, but more can be done than simply adopting a stance of benign passivity. The "market promoting" interventions most likely to be effective are those directed to formal-sector institutions. Both incentives and assistance can be provided to facilitate testing of innovative programs to deliver low-cost financial services to non-traditional clientele.

Special efforts to develop Malawi's financial markets deserve a high priority precisely because these markets are so underdeveloped and so essential. Broader and deeper financial markets yield major gains by mobilizing and intermediating savings more efficiently. At the micro level, providing secure and remunerative deposit facilities for storing liquidity and accumulating savings will generate direct utility gains. Improving access to finance will enable entrepreneurs take advantage of income-generating opportunities and to smooth out income fluctuations. Banks, too, will benefit if they can develop financial technologies to operate profitably in the large, latent SME market. Malawi is too poor to undertake financial market programs as redistribution schemes, but it is also too poor to forego the efficiency and growth advantages of financial deepening.

Two final remarks will help to place the discussion in perspective. First, the relationship between finance and development is interactive. Deepening financial markets works no magic if it is not supported by developments in the economy at large. Efforts to increase agricultural productivity, maintain incentives for efficient industrial growth, and improve education and training, *inter alia*, must underpin successful development.

Second, it must be kept in mind that credit is a double-edged tool. While it can accelerate development of small enterprises, it can also be a fatal burden when used indiscretely. The goal, therefore, is not simply to extend more credit to SMEs, but rather to make more widely available an efficient mix of competitive financial services--deposits as well as loans--through formal, semi-formal, and informal institutions.

Endnotes

* Associate Professor of Economics, Northeastern University and Visiting Scholar, Harvard Institute for International Development. The paper is based on information compiled in Malawi during July, 1989 as member of a team headed by Donald Mead (under USAID Contract No. DAN-5426-C-00-4098-0). Special thanks are due to Professor Mead, Yusuf Kandango, Francis Makoza, Gilbert Lengu, and to Mr. Ch____, the katapila moneylender who shared business information on the condition that his identity remain confidential. Others providing helpful assistance include Pauline Peters, Robert Young, Roberta Mahoney, Don Henry, Clay Westcott, George Butler, and the many individuals interviewed in Malawi. Any errors are my sole responsibility.

1. The World Bank (1989) reviews this literature and provides an extensive bibliography.

2. This is not always so. The World Development Report 1989 notes that laissez-faire is not necessarily the best policy: "in some countries well-designed credit programs undoubtedly did improve resource allocation" (p. 58). Cho and Khatkhate (1989) conclude that interventions played a constructive role in Korean development. Bolnick (1987) makes a similar case for Indonesia.

3. Timberg (1979, p.31) acknowledges having relied on second-hand sources for information on the "commercial financiers." in India. A later version of this study is Timberg and Aiyar (1984). Wilmington (1955) reports that government officials were the source of information on moneylenders in northern Sudan.

4. For example, Ashe and Cosslett (1989, p. 28) report that by the end of 1984, Rural Banks in Ghana served over 220,000 deposit customers but less than 32,000 loan clients.

5. This observation is based on field interviews. Available statistics do not enumerate the number of accounts, let alone by type of depositor.

6. Formal interest rate controls were eliminated in 1989 as part of a structural adjustment program. The banks responsed with a move to reduce deposit rates, prompting the Reserve Bank to intervene with "advice" on interest rates. (Source: interviews at the Reserve Bank and the commercial banks.) With a duopoly banking system--particularly under credit ceilings--government intervention may hold deposit rates above where they would otherwise be.

7. Shipton (1989) found that smallholders in the Gambia avoid formal-sector deposit institutions in part because of illi-

quidity preference. They want to hide assets to keep them out of reach of relatives and friends, without having to deny their loan requests. One might contend that Malawians are simply too poor to save, but this claim is refuted decisively by experience such as that of the Grameen Bank in Bangladesh and the Syndicate Bank in India (see Timberg, 1988).

8. Source: documents made available through AID's READI Project Office in Lilongwe.

9. MUSCCO = Malawi Union of Savings and Credit Co-operatives. Information on MUSCCO is based on interviews with MUSCCO officials and on consulting reports for USAID.

10. The life insurance policies (underwritten by the World Council of Credit Unions) pay to beneficiaries twice the share balances of the deceased, plus the balance on outstanding loans. Since this is the only life insurance policy available to poor Malawians there is a major risk of self-selection bias: individuals in high mortality-rate cohorts (such as the elderly) may be represented disproportionately in CU membership.

11. Approximately 17,000 Malawian enterprises hold business licenses in industry or trade. Very crude estimates of the number of non-farm SMEs run as high as 182,000 (READI, 1987). Adding farm enterprises--which are certainly represented among CU membership--the number of productive enterprises could be closer to one million.

12. See, for instance, Cole and Park (1983); Timberg and Aiyer (1984); Johnny (1985); and Onoh (1980).

13. Informal trade credit appears to be far more common within the Asian community. Concerning sales credit to consumers, different informants reported widely divergent terms. One claimed that customers face a 50% premium to buy on credit; another cited an implicit charge of 5-10% relative to the cash price; a third stated that typically no markup is involved.

14. Yusuf had borrowed on these terms. In such transactions it is unclear whether the agent also takes a share of the moneylender's 40%. For example the interest charge might be cut 20%-30% rather than 10%-40%. .

15. The katapila himself did not elaborate on the methods of encouragement. One interviewee alleged that strong-arm tactics are used, but this was firmly denied by all other sources with whom the issue was discussed. Chimedza (1989, p. 13) indicates that physical intimidation does occur in Zimbabwe.

16. One Malawian explained that traditional people believe dishonor befalls surviving relatives if the deceased is buried

with outstanding debts. Haunting or curses are perceived as possible consequences.

17. This is approximately the number of loans in Mr. Ch_____'s portfolio as of mid-July, 1989. Since the visit took place shortly after the annual harvest the seasonal loan cycle was probably near a trough at the time. In any case, the conclusion reached here is largely independent of volume of loans.

18. If agents share the moneylender's 40% charge (see footnote 23) the latter still earns a financial rate of return in excess of 100% per annum, using the assumptions stipulated here. But simply factoring in compounding boosts the profit rate to over 300% p.a.

19. Gilbert Lengu, of the Reserve Bank of Malawi, suggested the cultural hypothesis presented here. The short quotation is also from Lengu.

20. Chipeta and Mkandawire report that many moneylenders, unlike Mr. Ch_____, levy an interest premium on late payments.

21. Of 1300 non-agriculatural SMEs surveyed in READI (1987) only 3 reported <u>katapila</u> loans for business investment. It is instructive to compare the <u>katapila</u> interest rate of 40% per month with the "high" interest rate policies introduced in Indonesia on BKK loans (2.3% per month) and KUPEDES loans (1.5% per month on initial balances). See Patten and Snodgrass (1987).

22. Liedholm (1989) likewise concludes that highly segmented IFMs in many countries fail to meet the financial needs of SMEs, and are not well suited for financing productive capital formation.

23. See, for example, Timberg (1988), Coale and Park (1983), Bhatt (1988), Patten and Snodgrass (1987), Miracle (1983), Johnny (1985), and especially Ashe and Cosslett (1989).

24. See Nisbett (1973) and Miracle (1973), among other papers in AID's <u>Spring Review of Small Farmer Credit</u> (1973). More recent discussions include Chandavarkar (1988); Seibel (1988); and Sanderatne (1989).

25. The Government of Malawi (1987) notes this option but provides no clear statement of policy. Programs in low-income communities in Indonesia (Patten and Snodgrass, 1987) and India (Bhatt, 1988), among others, demonstrate the potential for profitable bank lending.

26. Loan guarantee schemes have also been widely discussed, but the sobering survey of Levitsky and Prasad (1987) invites deep skepticism.

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Table 1

Deposit and Loan Rates in Malawi

July, 1989

Institution	Deposit Rates	Lending Rates
Commercial Banks	10.75% savings acct. 12.75% 3-month TD 13.00% 6-month TD 13.25% 12-month TD	17% for agric. 22% maximum
INDEFUND	- not applicable -	16.5% for agric. 18.5% for mfg. 20.5% working cap.
SEDOM	- not applicable -	18% mini loans 18% term loans
Credit Unions	5% + dividends (if any)	18% regular loans 16% term loans
POSB	10.75% (tax free)	- not applicable -
New Building Soc.	10.75% savings acct. 13.25% 6-12-month TD 13.75% 12-24-month TD	13.75% owner occ. housing 19% rental housing 20% commerc'l prop.
Leasing Finance Co.	13% 3-month TD 14% 6-11-month TD 15.5% 12-month TD up to 19% 60-month TD	25% on declining balance

For comparison:

The inflation rate (Composite Retail Price Index) for the 12 months ending February 1989 was 26%

Reserve Bank economists estimated that inflation had fallen below 20% by July 1989, and predicted an annual rate as low as 12% by year-end 1989.