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THE POTENTIAL FOR FINANCIAL INNOVATION IN SMALL AND MICRO ENTERPRISE PROMOTION

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THE POTENTIAL FOR FINANCIAL INNOVATION IN SMALL AND MICRO ENTERPRISE PROMOTION: A SUMMARY

The papers in this publication, presented at an ARIES sponsored seminar on "Financial Innovation for Small Scale Enterprise Support" on January 28, 1988 in Washington, D.C., offer a variety of approaches to the development of instruments that provide financial services to small and micro businesses at terms that both beneficiaries and providers of the services can agree on.

The experts on financial development have identified the provision of financial services to small and micro businesses as essential to the achievement of overall economic development in developing countries.[1] This provision reduces transactions costs and consequently improves the production efficiency of enterprises. It likewise opens up foreclosed transactions and enables financially squeezed enterprises to participate once more in the general economy. In the long-run, the extension of the services helps integrate small and micro enterprises into the discipline of financial markets.

The availability of a wide range of financial instruments makes the movement of capital resources from sufficient to deficient units in the economy easy and relatively cheap. Ready and quick access by lenders to information about the risks posed by potential borrowers makes transaction costs even cheaper. Easy access to information about a potential borrower reduces the lender's perceived risk in dealing with the former. Moreover,

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1. Gurley, Shaw, McKinnon and Frye.

the availability of information about a greater number of small and micro enterprises further reduces the risks associated with these economic entities through risk-pooling.

A novel instrument that may deserve particular attention is group lending. Although a simple and comfortable group lending dynamic structure is yet to be established, its absence has not hindered the FEDECREDITO project in El Salvador, the CIDES cooperative project in Colombia, the solidarity group component of the PRODEME project in the Dominican Republic and the Grameen Bank group project in Bangladesh from becoming successful.

The consensus among many concerned economists is that the successful provision of financial services to small and micro enterprises can only be justified as part of a specialized financial development program. Otherwise, it only patronizes the inefficient and suboptimal transfer of financial resources to a small select group of borrowers and distorts capital prices. The inequitable distribution of resources reduces the overall efficiency of the economy and constrains economic growth.[2] There exists empirical evidence which shows that small enterprise credit programs may lead to inequitable distribution and not increase the volume of small enterprise activities.

Nonetheless, the intrinsic merits of providing financial services to small and micro enterprises, in general, can not be undermined. Small enterprise credit programs may increase overall economic efficiency through

2. Sandesara, J. C., Meyer at Micro-enterprise Conference

the creation of innovative financial instruments that lower transaction costs. The programs likewise may promote economic growth and equity, although only to the degree that the environment where they are implemented will allow.

Every possible way to get the small enterprises to participate in and benefit from the financial markets needs to be explored. The ideas encapsuled in this publication modestly break a path for this.

I. WORKING CAPITAL CREDIT FOR LDC SMALL BUSINESSES

WESLEY C. WEIDEMANN, PH.D.

Introduction

Small businesses in developing countries often do not have access to formal credit institutions for reasons which are related more to the cost of processing small loans than with the lack of credit-worthiness of the recipient. Commercial banks are generally not equipped to process small loans because of the labor intensive methods used to process and appraise loans. The concomitant costs of processing small business loans make it difficult for commercial banks to justify small scale lending.

Commercial bankers often require excessive collateral as a means of avoiding the costs of evaluating the credit-worthiness of an individual or of a particular project. Credit guarantees can serve as collateral, but this simply transfers the cost of evaluating credit risk from the lender to the guarantor.

Retail bankers can overcome the cost of processing and evaluating small loans by increasing interest rates, using less rigorous credit appraisal techniques and accepting higher losses, or offering packaged loan products (e.g., standardized car loan).

Banks in turn often are not interested in loan guarantee programs for small business because of the problems in collecting the guarantee funds and a guarantee does not address the problem of the high cost of processing small loans.

The major sources of credit for existing small businesses are suppliers who offer terms to some of the small businesses they deal with. Suppliers are, in effect, the bankers for small business inventory loans. Suppliers know their business, know the borrower, know which customers are overextended, and know the general status of the business environment. These are all characteristics of a good lender.

Suppliers generally would like to extend further credit to small businesses as a means of increasing sales, but lack of information on credit-worthiness of individual businesses hinders them. Suppliers may be reluctant to extend additional credit terms since this increases their overall risk position.

Following is the outline of a suggested credit guarantee program which works through suppliers and addresses the concerns of the lenders, the suppliers and the businesses themselves. This suggested program was originally conceived and designed to be used in Jordan. It has not yet been put into operation, and because of government apprehensions it is now on hold. However with appropriate modifications the program would be relevant for many other developing countries.

Assistance to Small Business through Supplier Credit

Many small businesses are able to establish unsecured credit with their suppliers in instances where bank credit is not available. A typical large supplier may extend credit of $1,000 to 300-400 small enterprises. The supplier can deal in smaller credit transactions than a bank because his return is far greater. For example, a supplier operating with a 20 percent markup on goods that turn over four times a year achieves a gross effective return on these assets of 80 percent per year, compared to a maximum rate of 8.5 percent allowed banks on financial assets. Therefore, a supplier can borrow from a bank to finance sales to smaller customers than the bank could do directly.

The religious, cultural and legal restrictions on interest and the perception of usurious applications of financial assets do not apply in the same sense to profits on investments in physical assets and merchandise. The most appropriate way to obtain the returns necessary for financing very small businesses would be some type of participatory arrangement with the supplier on the sale of merchandise.

Suppliers are limited by their own equity and willingness to assume risk as to the amount of credit which they can give small clients. For example, a supplier with $1,000,000 in capital funds might be able to borrow $500,000 from banks to finance receivables. The same supplier might have 500 customers, with an average capitalization of $25,000 and an aggregate capitalization of $12,500,000, permitting safe borrowing of, say, $6,250,000. As long as these small customers are not able to utilize their legitimate borrowing capacity fully due to the inability of banks with excess funds to service small accounts profitably and the limitations of suppliers' capitalization, the level of business activity and employment in the country will not be at the level expected from the capital base.

Suppliers have expressed interest in the idea of sharing credit information or setting up a credit information service on small businesses. Suppliers use credit to expand their client base only with caution, since it is difficult to ascertain the payment history of new customers and bad debts can rise quickly if care is not employed. In many cases, suppliers would be willing to extend credit to new customers, even without bank assistance, if reliable credit information were forthcoming.

The use to which the credit extended by suppliers will be put depends upon the terms and the nature of the business of the customer. For example, a 90-day credit extended to a business with a weekly merchandise turnover could be used for financing both inventories and receivables. While the system is being implemented and tested, credit should be restricted to a standard 90-day term, which will adequately cover most working capital needs. Later, when longer credit histories have been accumulated, these terms could be cautiously extended.

For most banks to be interested in such a supplier credit program, it would be necessary to be able to achieve higher returns, without violating restrictions on interest and without the necessity of the bank making a full-scale commitment to retail banking, especially with regard to bank layout and traffic. For example, if the normal return on one-year financial assets is 8.5 percent and the program returns 10.0 percent at comparable risk in a single transaction, most banks could be expected to participate. Since most commercial banks would already have some of these suppliers as customers, the ability of the bank to offer this additional service would enhance their relationship with these clients.

In order to reduce operational costs, the supplier credit program would make use of an embossed plastic identification card, similar to a credit card. The lack of the equivalent of a social security number, the number of similar names and the imprecision of mailing addresses make the use of such a card imperative if credit histories are to be accumulated accurately and fairly.

Also to reduce costs and to maximize the accuracy of payment histories, purchasers would be required to liquidate the transaction at a bank designated to receive such payments. Bills are ordinarily paid to collectors who visit the purchaser's home or place of business. With an imprecise system of addresses, mail collection is not feasible. Introduction of modern collection procedures is vital to reduce transaction costs. Although less convenient to the purchaser than having a collector visit his place of business, payment at a nearby branch bank is reasonable, especially when one considers that the customer did not need to visit a bank to receive the credit; he just had to visit the supplier.

Controlling the Credit Risk on Supplier Credit to Small Business

Interviews with some banks and with suppliers revealed that most small businesses are at least as good credit risks as many larger firms. Losses ranging from nominal amounts to 2 percent have been observed in consumer credit in other parts of the world. In fact one banker expressed the opinion that small businesses are intrinsically more credit-worthy than large businesses. Larger businesses can use political influence in making the determination of whether to repay loans, especially from government entities. Smaller businesses, he observed, have fewer options and therefore make a greater effort to repay loans to maintain access to future credit.

Although some bankers expressed the opinion that small borrowers were not concerned with their credit rating and could not be expected to act as if they were, the consensus was that most small business people are honest and anxious to maintain their name and reputation. Without an established credit information system, such conclusions, of course, are merely speculative. It would be highly unlikely that any person who intended to stay in business could regard an efficient system of providing credit information with disdain. A successful credit information network that is universal and accurate can effectively bar the poor risks from receiving credit from suppliers or banks anywhere in the country. The poor risks are placed at a competitive disadvantage from others who are better financed. Without an effective credit information system for small business, thousands of deserving entrepreneurs are deprived of resources because of the actions of a relatively few poor risks.

The proposed supplier credit program calls for joint action of many banks and suppliers in a single, unified system. In this way, the credit experience of one member is immediately available to all the others. A unified system also provides economies of scale in processing transactions.

The second element in the supplier credit system is the joint participation of the supplier in the risk. Under the terms of the agreement between the banks and the suppliers, if only partial payment is made, the bank is reimbursed before the supplier. All transactions must first be approved and proposed by the supplier and depend upon the subsequent approval of the banks. In all transactions, the supplier matches the bank in the amount of credit extended on equal terms and conditions.

The third element in the system is the pre-qualification of small business participants. Initially, it is swggested that the system should be restricted to the persons who can meet all of the following qualifications:

1. The firm must have been in business for at least six months at the same address.
2. The firm must be legally registered.
3. The firm must be recommended by at least two of the suppliers or banks that make up the system. Such a recommendation would mean that the firm was not in default on current transactions and that past experience has been satisfactory.
4. The firm's principal must have attended a video-taped session that explains the nature of the supplier credit system, the requirement of liquidating transactions at a bank, and the impact of delayed payment upon future use of the system. The applicant must also have been made aware that information on his credit history will be available to any bank or supplier participating in the system.

Finally, the most important way to control credit risk is to develop a national system of quick, accurate information about the payment history of small borrowers. If suppliers throughout the country have easy, low-cost access to an effective credit checking service, it is unlikely that anyone who wants to stay in business will intentionally default on an obligation.

The Establishment of a Credit Guarantee Fund

In order to induce bankers to come together and develop a credit facility for very small businesses, it is suggested that a credit guarantee fund be established. The purpose of donor involvement in this fund is to remove the operational risks of establishing a new credit program.

Due to the small size of the loans, a single, nationwide facility is suggested so that the operation may benefit from economies of scale. For efficiency, the nature of the guarantee should be in the form of a subordinated participation by the donor rather than guarantees of individual transactions.

Banks would be invited to pool monies to be applied in this program in a common fund, with the contributions matched by the donor. Profits from the operation of this fund would be distributed to all participants in proportion to their share in the capital, after establishing a reserve of 5 percent of assets for loan losses. Contributions would be for an initial period of three years, with extension beyond that time depending upon mutual agreement of the participants.

If at the end of three years an institution wishes to withdraw, having given six-months notice, its share of capital and accumulated reserves will be paid. However, if loan losses have been so great that the amount to be distributed is less than the capital initially invested, the difference will be paid out of the share contributed by the donor. If the fund continues to operate profitably after such a payment, the donor's depleted share will be reconstituted out of future income. If the fund is liquidated without such reconstitution, the donor will absorb the loss up to the amount of its initial contribution.

By agreeing to supply funds with a subordinated claim on assets in the case of liquidation, the donor will be giving a partial guarantee on the loans, without the administrative overhead and cost of insuring individual transactions.

The common loan fund will in turn finance 50 percent of approved credit transactions of certain suppliers. Therefore, the total amount of financing, assuming a $5 million contribution by the donor, will be at least $20 million.

Contribution by donor	$5,000,000	
Contribution by banks	$5,000,000	
Financing by Suppliers	$10,000,000	(outside fund)
Total Financing	$20,000,000	

Since the donor guarantee is in the form of a subordinated participation in a common fund rather than a guarantee on individual loans, risks are covered not only by other participants but by the borrowers themselves to the extent that their combined fees are sufficient to absorb bad loans.

It would be expected that loan losses of a properly managed fund will not be large enough to deplete the donor guarantee, and if losses are exceeding revenues the participants would most likely halt operations. The goal is to demonstrate that this type of operation is commercially feasible, so that banks and suppliers will be motivated to greatly expand the availability of financing to small enterprise. The mechanism of a common fund allows banks to increase their participation as they become confident in the system, eventually reducing the donor's percentage in the fund to a minor amount no longer relevant as a guarantee. The donor funds could then be withdrawn from the fund and reallocated to another purpose, such as small business education and training.

The reason for donor involvement is to encourage participation in the common fund and general support of a credit information system for small enterprise, rather than funding the financing to any appreciable degree. However, if the donor contribution helps to bring the bankers and suppliers together to set up a successful system, there is little doubt that substantial funds will be forthcoming from the private sector.

Criteria for Selecting the Financial Institutions To Manage the Fund

Since the loan portfolio will be managed as a common fund in which the donor will have not more than a 50 percent participation, the selection of the manager will depend primarily upon the institutions that put up most of the money. However, the donor should use the following criteria in deciding whether or not to participate.

The banks participating in the fund should represent a large percentage of the financial community in terms of total loan portfolios and branch networks.

The manager of the fund should be chosen by the institutions participating, who are in the best position to judge capabilities, staff competence, operational efficiency, portfolio quality and organizational experience.

The manager of the fund should have brought together the participants, organized the fund, obtained government approval, and proposed the detailed operating plan and budget.

The stimulus for organizing the fund should come as an invitation for proposals. The group which puts together the best proposal should be selected. The minimum conditions should call for at least $5 million to be contributed by a group of not less than five banks, the third ranking contribution to be not less than $500,000.

The proposals should specify an annual management fee of not more than 5 percent of the value of the portfolio. The proposal should also specify the need for an initial subsidy to set up the systems and market the concept. The donor should have the benefit of experienced and competent advice in the selection of a fund manager.

The banking community would not have to meet any special criteria for participating in the fund other than a minimum investment of $300,000.

Operational Procedures of the Guarantee

In order to keep administrative costs down, the supplier credit should be furnished through the fund by a credit card system. Figure 1 provides an illustrative overview of how the system would work. The following procedure is suggested:

1. A small business person submits an application for a supplier credit card through a supplier, bank, or trade association to the fund administrator. The application must first be approved by one of these intermediaries that are associated with the system.
2. The administrator of the fund will approve or disapprove of the application in accordance with general guidelines approved by the participants in the fund.
3. The total amount which may be borrowed on the card should not exceed $6,000. The donor subordination agreement should stipulate that the average loan in the portfolio may not exceed $3,000.
4. The term of a loan may not exceed six months. The donor subordination agreement should stipulate that the average loan term should not exceed 90 days.

5. Loans may only be made to finance bona fide purchases of merchandise from suppliers associated with the system. Not more than 50 percent of the value of each purchase will be financed by the fund, and the financing may not exceed the amount financed on equal terms by the supplier.
6. The supplier will obtain prior approval of each transaction by telephone from the administrator. The administrator will register each approval on a database and ensure that the credit limits of a borrower are not exceeded and that credit is not extended to cardholders who are in arrears on other transactions.
7. The supplier will process the transaction in the normal way that credit card sales are handled, except in this case, the fund (through a participating bank) will advance only 50 percent of the transaction, placing the other 50 percent for collection. The supplier will have no liability for the 50 percent advanced as long as the transaction was bona fide and exempt from fraud. However, the supplier's portion which is in for collection will be subordinated to the 50 percent due the fund.
8. The total amount of loans outstanding through a single supplier should not exceed 5 percent of the value of the fund. If loans processed through a certain supplier show excessive late payments or losses, transactions with this supplier will be limited or avoided.
9. All suppliers in the system can obtain credit information on any cardholder from the administrator without charge.
10. For the service of collecting the bill and advancing 50 percent of the transaction, the supplier pays the fund a fee of 5 percent of the

transaction. There is neither an interest charge nor a late payment fee.

11. The supplier provides the customer with a form to present to the collecting bank when making the payment. Borrowers must agree to go to the bank to liquidate the transaction. The collecting bank or banks will be members of the fund and will receive 2 percent of each bill collected.

The system described is similar to the process used in credit card loans throughout the world, except that the amount advanced to the merchant is not more than 50 percent of the value of the transaction and the collection of the merchant's share is subordinated to the fund receiving the entire amount. The processing of transactions and cardholder accounts could easily be handled on modern microcomputers, using off-the-shelf database software.

If the program were successful in creating a credit reference system and in changing collection practices, the environment for small business credit will have improved significantly. For example, one large supplier stated that he would be willing to double his advances to small businesses, even without bank funding, if he were able to obtain reliable credit information. Another supplier stated he would be willing to pay to get access to a list of cardholders with their credit histories.

The return on the investment in the fund will depend on four factors: (1) the transaction fee charged the supplier; (2) the transaction turnover per year; (3) the loan default rate; and (4) the administration fee.

The system suggested is novel only in so far as it represents the combination of financial ideas already well tested throughout the world. The use of the credit card to finance small businesses is common practice in retail banking in many areas. The pooling of loan funds under a single manager is nothing more than the mechanism used in money market mutual funds in advanced countries. The use of subordinate agreements in place of direct guarantees is also an old tool in the financial world.
The proliferation of credit card equipment and micro-computers has brought standardized forms and low operational costs, plus easy access to the know-how needed to set up such a system quickly. Perhaps the only novel aspect of the plan is the idea that only 50 percent of the credit card transactions be financed and that the collection be handled through a bank, thereby making the supplier a co-financier of the small business.

Alternative Operational Procedures

The procedures suggested above are expected to be subject to modification during the organization of the fund and implantation of its systems. For example, the methods may be adjusted to conform to legal or administrative requirements. There also will be changes to attend special needs such as lending in outlying areas, advances made through guilds or associations, or longer term loans. However, nothing should be done in the initial stages which might compromise the commercial viability of the fund. The time to experiment with "bells and whistles" is when the fund is healthy and operating profitably.

Two common loan guarantee methods were considered and rejected. The direct guarantee of a portion of individual loans was eliminated as being too expensive (labor-intensive) to manage efficiently. Loan insurance was also dismissed due to the problem of adverse selection of risk and the lack of statistics on which reasonable insurance criteria could be based.

Method of Monitoring Resources

A small business loan fund could be set up as a common trust fund under the fiduciary responsibility of a leading Jordanian bank, the problem of monitoring the operation is simplified. The fund would be audited regularly by a firm that had the confidence of all the participants, including the government and the donor. The initial subordination agreement would spell out the items to be reported periodically, as well as the parameters of the lending operations. Should these conditions not be met, the subordination agreement would become inoperative and the donor would be entitled to redeem its participation. The auditors' report will include statistics that will help evaluate the success of the project such as number of businesses financed, indications of their size and nature, loss ratios, average size and term of loans, and numbers and types of suppliers and other intermediaries.

Neither the donor nor the government should become involved in the day-to-day management of the fund. Neither should onerous reporting nor monitoring requirements be imposed. However, the initial subordination agreement should provide that the donor guarantee would be contingent upon fund management following certain guidelines with respect to average loan size, type of borrower, loan purpose, loan terms, and reporting and auditing requirements. Failure to meet these guidelines would automatically remove the subordination guarantee.

It is essential that the donor have the advice and counsel of someone with senior experience in banking and negotiation of the organization of financial funds, at the time the agreement is being worked out.

Criteria for Participation by Suppliers

The primary qualification for suppliers to participate in the system is approval by one of the banks contributing to the fund. The total advances made to any one supplier should not exceed 5 percent of the value of the fund nor 20 percent of the sales of the supplier. Suppliers who approve advances that result in losses above a limit established by the fund manager from time to time will be limited or dropped from the system. Suppliers selected must also normally provide similar terms to customers and must sell directly to small businesses. The limitations on the nature of the cardholder, the size of the loans, and the terms of the transactions will automatically select suppliers with a role in informal credit markets whose standard business practices will benefit from the system.

Avoidance of Risk Transfer from Suppliers to Fund

Any loan from the fund must be approved by both the administrator and a supplier who belongs to the system. The administrator's approval will indicate that (1) the borrower is a cardholder with an approved credit agreement; (2) the borrower is not currently in arrears; (3) the amount of the loan will not result in the borrower's total outstanding exceeding his credit limit. The administrator gives approval by telephone, and the transaction approval is verified by a code number. In areas where telephones do not operate dependably, a purchase limit could be established which could not be exceeded by a supplier. The supplier approves the transaction by making the sale and agreeing to receive payment of 50 percent in 90 days.

Advances will be made only for bona fide transactions involving the sale of goods or services by the supplier to the cardholder. The supplier must deliver the goods to the cardholder at the time of sale. The price of the sale may not exceed the normal cash price by more than 10 percent. Fifty percent of the sales price must be financed by the supplier on terms identical to the amount advanced by the fund. The entire bill will be collected by a bank associated with the system.

If the cardholder returns the goods for a refund, or if the transaction is cancelled for any other reason, the supplier must advise the administrator to cancel the collection, returning, at the same time, the amount advanced.

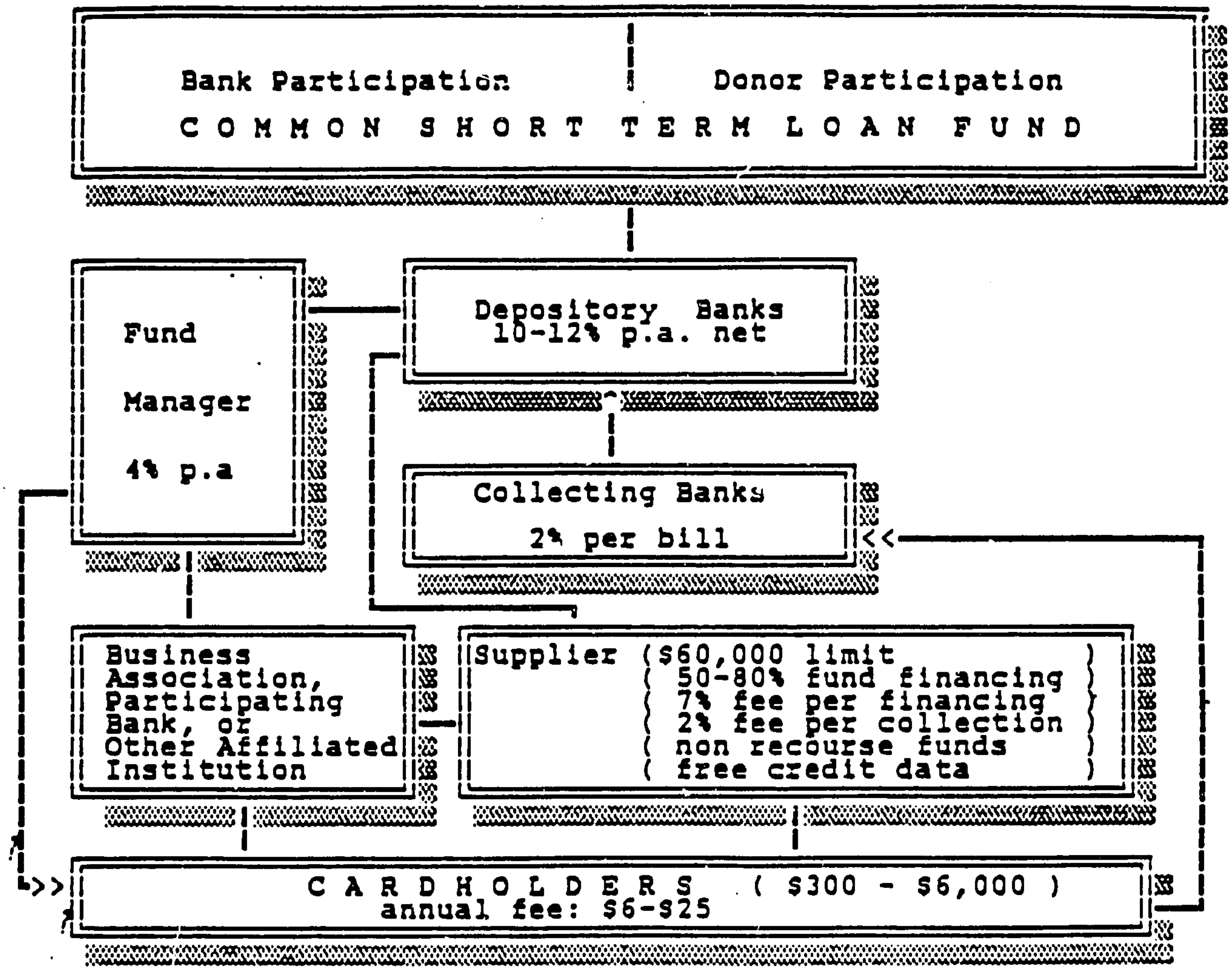
If any supplier does not follow these rules, the administrator, considering the circumstances, may refuse to allow him to continue to participate in the system. The credit agreement between the fund and the supplier will provide that the supplier will be fully liable for any advances made by the fund due to misrepresentations by the supplier, or collusion between the supplier and the cardholder.

The administrator will continually audit transactions on a spot basis to assure that the rules are being followed. Such spot checks should cover all suppliers at least once a month. All late payments should be audited.

Although there certainly will be dishonest suppliers and cardholders who will attempt to take advantage of the system, the fund should not be seriously impaired since the risk is widely diversified and the systems for detecting credit card fraud are well developed. Assuming that the initial fund amounts to $10 million, matched by supplier participation, the maximum exposure to a single borrower will be 0.03 percent. A supplier who attempts to misuse the system will be discovered in 90 days when the collection comes due. When a supplier is expelled from the system, this would be reported to all other banks. The supplier would be cut off from the credit information system, and the fund would take action to collect the amounts lost.

Figure 1

SUPPLIER CREDIT SYSTEM



II. FINANCIAL SERVICES FOR SMALL AND MICRO ENTEPRISES: A NEED FOR POLICY CHANGES AND INNOVATION

RICHARD MEYER
AND
GEETHA NAGARAJAN

Introduction

The great concern that exists today for providing financial services to small and micro enterprises is reminiscent of the flurry of activity in the 1960s and early 1970s to finance small farmer credit programs. The approaches, the rationale, the political concerns, the earmarking and the targeting of funds are similar to that earlier period. The generally negative evaluation of that small farmer experience, especially in terms of the failure to build strong, viable, self-sustaining financial institutions to serve small farmers, suggests a need for caution in the current enthusiasm for financing nonfarm enterprises. It is important to analyze the small farm experience with a view towards identifying those factors that may determine success or failure for small and micro enterprise financing projects.

There are two purposes for this article. The first is to briefly review the small farmer experience, and the second is to identify areas of policy change and innovation that emerge from that review which can guide the design of projects and programs for small and micro enterprises. Since the Grameen Bank is one of the most interesting innovations in recent times (and which gets a large, perhaps excessive, amount of publicity), an attempt is made to identify lessons learned from its experience.

No distinction is made in this paper between small and micro enterprises. Although there are differences and the differences may be important for some purposes, what is of concern from the financial perspective is that the clients are small operators, mostly individual proprietors, operating out of their homes and/or workshops, producing and/or marketing products using fairly simple technology, with no or simple business accounts, self-financing most of their investment and working capital, employing few workers, and facing considerable risk in the supply and price of inputs, and in the price of outputs. Most have had no experience with formal financial intermediaries, or at most they use only checking and savings services. Most are not very attractive customers to the commercial banking sector compared to larger, more sophisticated clients who maintain more extensive written accounts. Many of these enterprises are located in rural areas or small towns where financial services are not readily available for either farm or nonfarm clients. Many are linked through backward or forward linkages to the agricultural sector, so their success depends greatly on agricultural performance.

The Financial Services Problem

The financial "problem" with respect to small nonfarm enterprises, as perceived by policy makers, appears to be similar to past perceptions of the small farmer credit problem. The enterprises are perceived as being small, backward, unproductive, and a drag on economic growth for several reasons, but an inadequate supply of low interest, long term credit is identified as a major problem that policymakers think they can do something about in the short run. Short-term working capital may also be perceived as a problem but it is expected that entrepreneurs can more easily obtain credit for such capital. Existing financial intermediaries are perceived as being conservative, risk averse and uninnovative with respect to small enterprise lending, and prefer instead to concentrate their loan portfolio on larger enterprises or financing large scale commerce and trade. The "need" of the small enterprises is loans and no consideration is given to the value of banks providing a supply of safe, dependable deposit and savings services. If these enterprises borrow, it is usually short term and emergency loans from informal sources that are seen as charging usurious interest rates.

The Response of Policy Makers

Faced with this perception of the problem, policy makers have introduced several measures to finance small farmers, and many of these are now being introduced in small enterprise projects.

1. Increase the supply of funds available for lending to the priority sector (small farmers or enterprises) through:
   a. portfolio quotas or targets for existing lenders;
   b. the creation of specialized financial institutions to work only with the priority sector(s);

c. lending by non-financial institutions (ministries, departments, institutes); and

d. rediscount programs through the central bank, often funded by donors.

2. Reduce the interest rate of loans to the priority sector through:

a. interest rate ceilings which set the lowest rates for the smallest/poorest borrowers;

b. low interest rates charged on refinance funds provided by the Central Bank;

c. encouragement to banks to cross-subsidize by charging higher rates to non-priority borrowers in compensation for low rates to priority borrowers;

d. mandatory placement of private and/or public deposits in specialized lending institutions; and

e. direct government interest subsidies to lenders.

3. Reduce lending risks and costs through:

a. targeting loans for purposes assumed to be profitable and/or priority;

b. crop and loan guarantees;

c. creation of joint liability through lending to groups of borrowers; and

d. technical assistance to lenders to help improve institutional efficiency.

e. establishing lines-of-credit for preferred borrowers.

4. Nationalization of banks that fail to meet social objectives.

Problems of Projects and Programs

In some cases the measures taken by policy makers have succeeded in temporarily expanding lending to the priority sector. Some institutions have gained experience in lending to a new clientele and some have introduced innovations to more effectively serve customers. The failures are more numerous, however. They have been extensively documented elsewhere and will only be summarized here.[1]

1. Quotas and targets have been ignored or evaded by means such as creative loan documentation and multiple small loans to large borrowers.
2. Lenders accept the alternative to lending such as buying low interest government securities.
3. Interest rate controls result in nonprice rationing of loans resulting in high borrower transaction costs and a concentration of loans among wealthier borrowers.
4. A diversion of cheap loans from intended purposes into higher return activities, and the substitution of borrowed for own capital.
5. Political intervention to direct "cheap" loans to particular clients and to protect delinquent borrowers.
6. High lender transaction costs due to heavy reporting requirements.
7. High loan delinquency and default.
8. Weakening of institutions because of high lending costs, low loan recovery and a failure to mobilize deposits.
9. Institutions are unreliable from the borrower perspective

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1. Examples include Adams, et al., Ashe, Chew, Farbman and Lieberson.

because of their dependency on the whims of government or donor funding.

In short, viable, self-sustaining institutions have not been developed, a few fortunate borrowers may have enjoyed a one-shot increase in liquidity, close lender-borrower relations have not been built, and the difficult problems faced by priority borrowers have not been reduced so that they can become more attractive customers to financial institutions. If innovations have occurred they have often been designed to avoid rather than implement the intent of the decisionmakers.[2] The lenders have not developed the interest nor expertise needed to continue to effectively serve the priority sector(s).

The Grameen Bank Experience

The Grameen Bank in Bangladesh is one of the most publicized programs today designed to meet the financial needs of low income people. Its relative success in the midst of so many failures makes it worthy of special comment. The comments presented are derived from observing its evolution during the past ten years and reviewing in-depth studies of its operations.[3] Although it contains many innovative features, it must be recognized that there are similar programs in Bangladesh (especially the Swanirvor program) and elsewhere, but they don't have

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2. An explanation of this process is presented by Kane in "The Political Economy of Subsidizing Agricultural Credit in Developing Countries" in Adams, et al.
3. See the two volumes by Hossain (the latter of which will soon be published by IFPRI) and Nurazzaman.

the same recognized success as does the Grameen Bank.[4]

The activities which eventually evolved into the present day Grameen Bank began with the efforts of the founder, Professor Muhammed Yunus of the Department of Economics, Chittagong University, to obtain credit for the landless without collateral in an area near his university.[5] That initiative evolved from a program to assist borrowers to obtain credit from cooperating banks to an independent bank, partly owned by its low income clients.

The essential characteristics of the Grameen Bank are the following:

1. A bank branch with a Field Manager (FM) and several bank workers (BW) covers an area including 15 to 22 villages.
2. Persons with families owning less than 0.5 acres of land or assets valued at less than one acre of land are eligible for a loan.
3. The FMs and BWs travel among the villages organizing groups of five members who are like-minded and have similar social-economic backgrounds. Each group elects its own chairman and secretary and holds weekly meetings. Males and females belong to different groups.

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4. Some of the essential features of the Grameen bank, such as group lending, compulsory savings and the use of high interest rates can also be found in some micro enterprise financing projects in other countries. For example, group lending is practised in India, the Dominican republic and kenya. The insistence of savings is found in the PROMEDE project in the Dominican Republic and the BKK project in Indonesia. BKK also uses a market-oriented interest rate.
5. The initial program is described in Yunus.

4. After a month-long training period, the two most needy members are invited to submit loan proposals. The proposals are discussed in group meetings, reviewed by the BW, and eventually submitted for approval by the FM and zonal office.
5. Loans are collateral-free and repayments are usually collected weekly at the rate of 2 percent of the principal. If the first two borrowers use the proceeds as requested, make payments when due, and observe rules and regulations, the next two members will be invited to apply. If not, the remaining members automatically are disqualified. If one of the five willfully defaults, no new loans are made until all arrears are cleared.
6. Group members save one taka[6] per week plus five percent of the loan amount which is set aside at the time of disbursement. This Group Fund can be borrowed from in time of need at terms set by the group. An Emergency Fund is also created with payments of 25 percent of the interest due after the loan is fully repaid. It can be used to repay the loan of a member who is unable to repay due to accident or other unforeseen reasons.
7. The interest rate on loans is 16 percent, the going rate for rural areas, but the effective interest rate for the borrower is well over 20 percent because of the forced savings in the Group Fund and the Emergency Fund.
8. A male BW serves about 250 members while a female BW serves 150 members. They visit the groups weekly to collect savings and loan payments, and disburse loans. As of April 1986, about two-thirds

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6. The exchange rate has been approximately 25 taka = $1.00.

of the members were women and they received about 55 percent of the loans disbursed.

9. The Grameen Bank does not target loans. It basically finances non-crop agricultural and non-farm activities. Loans have been extended for over three hundred different activities. Initially, trading and shopkeeping represented the largest sector financed. As the share of female members rose, livestock and fishing sector loans expanded. Beginning in 1982, collective or joint enterprise loans were extended and these represented five percent of the amount of loans disbursed in 1985.
10. As of April 1986, the Grameen Bank had grown to over 200 branches, covering more than 4,000 villages with almost 200,000 members and over 1.1 billion taka in total loans disbursed. At that same date, over 99 percent of the loans had been recovered within one year of disbursement and over 99 percent within two years of disbursement.

Two issues are often debated about the Grameen Bank. One concerns the importance of Professor Yunus in explaining its success and the ability of the organization to maintain high performance in its rapid expansion. The other concerns the extent to which it grants subsidized credit. On this issue, there is some information. First, in one sense of the term, it does not engage in subsidized lending because it charges the same interest rate as do the nationalized commercial banks for rural loans, plus the implicit interest involved in the forced savings funds. Thus, the effective annual interest rate to the borrower is well over 20 percent. On the other hand, in 1985 its loan funds cost only 5.8

percent. An important reason was the relatively low 2.9 percent cost of funds from foreign institutions (largely IFAD), which represented almost 40 percent of total loan funds, compared to about 8 percent charges for funds received from the Central Bank. If it would have paid the 8.5 percent rate charged by the Central Bank to other lenders, its cost of funds would have represented 22.9 percent of loans and deposits. On the revenue side, it has maintained about half of its funds in fixed and term deposits which represent low risk and operating costs but earned an average rate of 12.5 percent interest in 1985. Thus the approximate 7 percent spread on financial operations helped compensate for the cost of lending operations. Whether or not this implicit subsidy is justified to cover start-up costs is an issue beyond the scope of this paper.

Need for Policy Changes and Innovation

The negative experiences of many farm credit projects as well as many small scale and micro enterprise projects suggest a need for major changes in the way that finance is viewed and handled in development projects. The fairly positive results enjoyed by the Grameen Bank, as well as some other projects, suggest areas for policy changes and future innovation:

1. Interest rate policy. Interest rates need to be high enough to cover lender costs, default risks and inflation. Only in this way can lending institutions/programs become viable and self-sufficient. Subsidies imply continual handouts from government and donors, on the one hand, going to a small group

of privileged beneficiaries, on the other hand. Interest rate policies must also be flexible enough to adjust to changes in cost of funds and inflation.

2. Targeting of loan funds. Loans are most valuable when they meet borrowers' needs; they are least valuable when borrowers are forced to use them for specific purposes. Borrowers are more likely to repay when they perceive the opportunity of getting a new loan.[7] Therefore, a whole household or firm approach, rather than an enterprise approach, is necessary for developing client-borrower relationships. Borrowers need the opportunity to borrow for their perceived needs. Because of fungibility of funds, loans will not flow into targeted purposes anyway if they are not perceived as profitable or useful.

3. Group lending. Lending to groups offers possibilities to reduce lender costs and improve loan recovery. In practice, however, attempts at group lending have often failed to discover the appropriate group dynamics that will actually produce the expected benefits. The solidarity group approach in the FEDECCREDITO project in El Salvador, the groups formed within the CIDES cooperative in Colombia[8], the solidarity group component of the PRODEME project in the Dominican Republic[9], and the Grameen Bank groups appear to be most successful. Successful groups appear to be small, homogeneous, and self-select their members.

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7. See further discussions by Kilby and D'Zamura, and Ashe on this point.
8. Discussed in Farbman.
9. Discussed in Ashe.

4. Loan payback. Loan repayment must be based on frequent loan installments, frequently weekly or daily. Establishing the habit of paying installments on a timely basis and even requiring repayment faster than easily generated by the cash flow of the project funded is important in establishing responsible borrowing.
5. Using financial institutions. Providing credit through nonbank rather than banking institutions usually increases opportunities for political patronage and results in sloppy lending practices, poor bookkeeping and ineffective or nonexistent loan recovery activities. Assisting entrepreneurs to obtain credit from regular banking sources helps them to become acquainted with bank procedures, gives them access to deposit and other banking sources, and helps familiarize the banks with the operations of potential new customers.
6. Developing close bank-client relations. The objective of a small enterprise project should be to assist entrepreneurs to become long-term customers of a financial institution. This should also be the objective of the financial institution. Therefore, both entrepreneur and banker should work towards developing closer bank-client relations which can lead to simplified banking procedures and lower transaction costs for both. Inventory norms may provide some guidelines in setting lending limits until information about individual customers can be obtained (Liedholm).
7. Savings mobilization. Financial institutions should strive to become financially independent by mobilizing a large share of their loanable funds. This will make them more immune from government pressures, improve discipline in financial operations, improve loan recovery and

provide important deposit and savings services to customers.[10] Examples of projects where borrowers have been forced to make deposits include the Grameen Bank, BKK in Indonesia, and the ADEMI project in the Dominican Republic. Voluntary savings deposits, however, would seem to be necessary if institutions are to mobilize sufficient deposits to achieve self-sufficiency.

8. Increase the spread of banking outlets. An expansion in banking outlets is the single most important factor affecting bank deposits.[11] It also contributes to rapid credit delivery, increased credit turnover, and lower administrative costs. Furthermore, by reducing costs, financial institutions can more easily afford to service small loans and deposit accounts needed by low income customers. Since formal bank branches are expensive to operate, some innovations are being explored, such as mobile branches which travel to towns and villages on market days and partial service branches.

9. Market linkages and the informal sector. Greater use needs to be made of nonbank institutions as a source of credit services. Subcontracting with larger firms can provide both credit and a secure market for output (Mead). Informal financial organizations such as ROSCAs are widely found in developing countries and may be linked to formal financial groups. Efforts are underway in Asia to develop more links between self-help groups and financial institutions to provide a place for such groups to bank their savings as well as increase their

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10. A more complete discussion of the importance of deposit mobilization is found in Meyer.
11. A test of factors affecting bank deposits in South Asia is found in Srinivasan and Meyer.

access to loans (Quinones). Credit unions represent an organizational form between small informal groups and formal banks that are being effectively formed in many countries. All these alternatives represent examples of ways to transfer high transaction costs from financial institutions that don't want to bear them to institutions and/or customers that are willing to bear them.

10. Risk reduction. Loan guarantees are frequently thought of as the best way to reduce risks to lenders. They frequently don't work well in practice, however, and often times simply represent subsidies hidden under another name. More effective ways to reduce risks are likely to develop (a) if lenders are permitted to diversify their loans in a particular location rather than target them on a particular enterprise or sector, and (b) if they are encouraged to distribute their risk across locations and/or markets through branching, secondary markets for loans, and liquidity funds.

Conclusions

Small farmer credit programs have generally been unsuccessful in meeting the needs of creating viable, self-sufficient financial institutions. In some cases they have simply provided a one-shot increase in liquidity for the borrowers lucky enough to get the loans. Far too frequently, the distribution of loans has been concentrated among richer farmers, transaction costs have been high for both lender and borrower, and loan recovery rates are low. Many of these same problems exist for projects targeting small nonfarm enterprises. The exceptional cases, including the

Grameen Bank, are worthy of analysis because of the insights that they provide on the innovations that may improve project performance.

Creating a more flexible set of rules and regulations under which credit projects operate is a necessary condition for creating long-term, viable programs. It is now fairly well accepted that more flexibility in interest rate policy is essential. Subsidized rates obviously provide benefits to borrowers, but the cost may be high in terms of the way they undermine the financial institutions. A wide range of other policy changes and innovations may also be usefully undertaken.

A key issue must be addressed by all policymakers, donors and NGOs interested in stimulating small enterprises. This concerns the economic environment faced by entrepreneurs and the extent to which this environment must be altered before they will become attractive clients to financial institutions. Subsidized credit cannot substitute for high input prices, low product prices, unstable input supplies, poor information and transportation systems, and complicated rules and regulations that favor large enterprises. Tinkering with credit policies and programs will not make unprofitable enterprises profitable.

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III. INSTITUTIONS, INSTRUMENTS AND TRANSACTIONS: WHAT FOCUS FOR FINANCIAL DEVELOPMENT?[1]

J. D. VON PISCHKE

Governments in virtually all countries attempt to stimulate financial innovation by creating new institutions that are intended to make financial markets function more effectively. These institutions are designed to expand access to formal finance, especially for clients, purposes or sectors regarded favorably by government. Examples include specialized agricultural credit institutions, cooperative credit societies, small enterprise development funds and similar intermediaries. Development assistance programs frequently support these fledgling institutions. Those that work in one country are often copied; those that do not work well are also often replicated abroad.

The objectives of special programs and new institutions are often regarded as highly laudable, enabling their sponsors to obtain domestic political support and development assistance funds for their implementation. However, their subsequent performance often exhibits serious problems. This paper suggests that problems arise when institution-building activities focus primarily on organizational structure, objectives and strategy, and overall performance. An alternative focus, on the instruments and transactions in which these institutions engage, is proposed. Traditional institution-building

1. Views expressed in this paper are those of the author. They should not be attributed to the World Bank, its affiliates or to individuals acting on their behalf.

activities are described, the role of instruments and transactions are explored, and a first person example is given as illustration.

Institutions and Institution-Building

Institution is used here to refer to organizations generally. Institutions are important because they can increase efficiency and arbitrate the claims of different interest groups. Institution-building is a task to which much effort is rightly devoted. This term is often used by development assistance professionals to refer to assisting a particular government department, parastatal corporation or cooperative to improve its management and operations by developing procedures and information systems, hiring qualified staff, obtaining equipment such as computers and vehicles, and erecting new buildings. These contributions are indeed useful when they succeed in promoting efficiency, even if they do not directly develop society's great institutions, such as markets, systems of justice and education and the framework for political decision-making.

Experience with credit and development finance company projects suggests that institutional development in the state-owned and cooperative financial sectors is stubbornly difficult. Efforts to support an institution may be counterproductive if its activities are poorly conceived or if its mission cannot possibly be accomplished. Efforts to build institutions with such problems lead to injections of good money after bad and have a high opportunity cost: the energy they absorb otherwise could have been directed towards tasks that could be successfully undertaken. It appears that there are no widely accepted criteria to determine when an institution can be usefully assisted, and when such assistance is likely to be dissipated or even to encourage inefficiency.

Potentially excessive attention to institutions in development projects is the result of several influences. The first is that development assistance is generally directed at or delivered through state-owned institutions. Governments create these institutions for political purposes, and they are important sources of patronage in terms of promising services to citizens and providing jobs to the faithful.

Second, development assistance agencies require a certain environment for the use of their funds. Project lending, by definition, sponsors activities that have a separate identity, activities that generally are not just part of the routine functions of the state sector or that would not be conducted on the same scale or with the same complexity without external assistance. Assistance agencies often prefer to work with "autonomous" or semi-"autonomous" state agencies that are perceived as having the flexibility required for creative tasks and that can use budgeting, procurement and accounting procedures preferred by external assistance agencies.

A third source of potentially excessive attention arises from institutional mystique and outreach. Cooperators want to establish cooperatives because they believe that cooperatives are a morally superior form of economic organization. University professors believe that instruction in their particular disciplines could be useful in another country. Strong believers in a popular form of government believe that its adoption would benefit the people of other countries.

This institution-building context, combined with development assistance funds, produces highly motivated secular missionaries whose objectives go beyond the skills they want to transfer. Their efforts are tremendously powerful when they are entrepreneurial and adaptive, extending to others the benefits of their expertise. But when they are narrow and imposed, they may be of only limited success, possibly wasteful, or ultimately destructive.

If financial sector institution-building as generally conceived and practised is a high risk investment for both donor and recipient, what developmental alternative can be offered? One alternative is to focus on transactions undertaken by institutions, which requires attention to financial instruments.

Instrument Defined

An instrument can be defined as written evidence of a legal claim.[2] A check is a financial instrument in this sense, for example. Instrument may be defined more widely as a financial product or service. In this sense a checking account is an instrument, as are savings accounts, letters of credit, forfaiting arrangements and credit union signature loans. Instruments so defined are vehicles for financial innovation.

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2. "Instrument: any written document that gives formal expression to a legal agreement or act." Jerry M. Rosenberg, The Investor's Dictionary (New York: John Wiley & Sons, 1986).

Defining instruments as financial products directs attention to transactions, to how financial products are sold. Institutions are delivery mechanisms—through transactions they meet and relate to their clients. Financial markets function through transactions. When transactions fail to attract clients or are structured so that relationships cannot be sustained, institutions will not be viable, become irrelevant, and are unlikely to fulfill a developmental role. The portions of financial markets dealing in these unsatisfactory transactions will languish.

This perspective suggests that efforts to stimulate financial development and to design credit projects should begin with transactions. The first task is to identify the types of transactions that are or could be useful to the people and for the purpose the project designer expects to serve. When the transaction objective becomes clearly defined and the transaction fully formulated, institutional form and content follow.

The benefits that could flow from a transactions approach can be illustrated by an example from the author's experience. In this example, failure to comprehend the nature and implications of the transactions required to implement the project resulted in loans that were probably not remunerative to the lender, that burdened the borrowers, and that failed to realize their potential developmental impact.

A Young Analyst Goes Abroad

One of the writer's early experiences with development projects was as a member of a team that appraised a small farm credit project. The institution that would implement the project was having difficulties with financial housekeeping: tremendously large cash balances were held in a local bank. These balances were large for precautionary reasons. It took about three months to reconcile the numerous bank accounts the institution maintained for its own convenience and to accommodate donors' requirement that separate accounts be maintained for each project, and disbursement of a loan commitment could take up to six months. Hence, this farm credit institution did not know its cash position, which is generally the first priority of financial intermediaries, and kept large balances to ensure continued operation. Even with this cash cushion, lending was suspended from time to time because it appeared that liquidity might be depleted.

Loan repayments collected from farmers were mediocre, and repayments on certain large loans were delayed for months or years because the government's loan guarantee program was inefficient.

Suspense accounts were generously used for transactions that were not properly handled. External audits by a multinational firm appeared less than thorough, and the auditor's opinion did not seem to square with the facts. Annual reports were published greatly in arrears because of governmental review procedures. Trends in the financial statements, such as they were, suggested that financial reorganization might be necessary during the expected disbursement period of the project the team was instructed to design.

Two development assistance agencies had provided specialists to review the situation, and their report awaited us. Our team spent considerable time negotiating with the institution's management, the report's authors and Ministry of Agriculture officials to agree on a plan for institutional development. Objectives were to upgrade accounting performance, to train staff, and to obtain more equity capital by converting to equity a loan that the government had made to the institution. The team left the borrowing country confident that progress would be made.

These discussions occurred after five years of a major donor's support for the institution. Recently, after about 20 years of involvement, an official of the agency sketched a rehabilitation plan for the farm credit institution. The problems enumerated were generally the same as those the author investigated in the early 1970s. They had endured throughout the intervening period, which had been punctuated by suspensions of lending by the institution because of accounting and other internal problems.

Concentration on the institution appeared logical to the author's team and identified problems that inhibited good lending and effective financial management. The author analyzed the institution's finances, which corresponded with his training and the way in which the institution's problems were defined by all involved. Institution dealt with institution.

A Transaction Focus: Different Questions, Different Answers

Loan terms. A transaction focus might have yielded a useful and sustained contribution to development. A clue that the team might have picked up was that the lender's accounting problems provided an incentive to minimize the number of transactions. This would hopefully permit the accounting department to work down the backlog of entries. However, the objective of the institution, the government and the donor was to expand lending. The institution's traditions and the interaction of these forces resulted in repayment schedules for medium- and long-term loans requiring farmers to make annual installments. In other words, one characteristic of the instrument selected to implement the project was annual repayments over the life of the loan.

The project provided credit primarily for dairying. Income from dairying occurs daily as cows are milked and as milk not consumed on the farm is sold. Could small dairy farmers be expected to accumulate enough cash throughout the year to make a single payment? Convenience to the borrower favors loans repayable in frequent installments. Could the farm credit institution modify the instrument by offering incentives for the prepayment of annual installments, in small amounts throughout the year? Clearly not, if transactions were to be minimized.

A significant proportion of borrowers had incomes from cash crops marketed through cooperatives and parastatal agencies, while others worked for the government as teachers, civil servants, and in the police and armed forces. Loan recoveries for these borrowers might have been made through deductions from cash crop delivery proceeds or from the monthly paychecks of those who worked for the government or for other employers willing to cooperate by splitting wage and salary payments, part to the lender and part to the farmer.

Linking savings and credit. Investigation would have shown that savings account facilities were not readily available. Therefore, poor repayment could be expected from those without relatively large incomes from cash crops or off-farm employment because of the formidable size of the annual loan installment. Loan collection problems would raise the lender's administrative costs and complicate its cash flow projections.

A transaction focus might have led the team to consider the promotion of savings facilities as a means of assisting farmers without off-farm employment or cash crops marketed through coops or parastatals. By linking a savings instrument with the credit instrument, funds could be accumulated throughout the year to meet the annual installment. Savings facilities could be offered by the farm credit institution (which would have to have good financial housekeeping to sustain confidence) or by banks and rural cooperatives.

Prioritization of assistance efforts. A transaction focus could have suggested several other alternatives. One would be no disbursements out of donor funds until housekeeping problems were solved, which might have required 18 months. Institutions have to record credit transactions properly to manage repayment risk effectively.

Transactions and the target group. Repayment terms probably reinforced the tendency for loans to flow to relatively better-off operators rather than to the project's intended target group. Many small farmers with low incomes who understood the implications of an annual installment for a dairy loan and who wanted to avoid default would obviously avoid borrowing under the project. This realization could have led the team to consider alternative instruments or alternative forms of assistance structured to attract members of the project's target group of small farmers.

Attention to transactions and accompanying costs might have led to support for artificial insemination rather than credit, and leasing or integration arrangements for cattle. These alternatives could have contributed

to institution-building, but not simply within the credit agency and the Ministry of Agriculture.

Cost analysis. Analysis was directed primarily toward the institution's overall revenues and expenses. Attention to transactions could have led the team to consider the costs of each transaction. From this, the overall costs and benefits of the project to the institution might have been derived. This calculation is seldom made in credit projects, and when it is done it is usually not rigorous. As a result, intermediaries can easily lose money by taking on a donor-supported project.

IV. INFORMAL FINANCIAL MARKETS

THOMAS A. TIMBERG, PH.D.

Informal Credit Markets (ICMs) is a term used vaguely to describe a wide variety of phenomena. These markets encompass financial transactions that are unregulated and sometimes banned by the government. ICMs are defined in contrast to formal financial markets, which as John Gurley says, are defined by the fact that they are regulated.[1] Some commentators on ICMs have tried to confine themselves to markets dealing with purely financial transactions, or even only ones that involve intermediation, but this, by excluding trade credit, excludes the bulk of financing that might be considered under the informal rubric.

ICMs are of interest because:

1. In many LDCs, they undertake a good portion of financial activity; and understanding of them is crucial for understanding the economy. Financial market interventions might otherwise be counterproductive. This is particularly the case as the attitude of donors toward financial markets has changed from looking on

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1. John G. Gurley, "Financial Institutions in the Savings Investment Process, I", ed. Leon T. Ketchum and Marshall D. Kendall, Readings in Financial Institutions (Boston: Houghton Mifflin, 1966), p. 14.

them as promoting and subsidizing agents for merit inputs (fertilizer, etc.) to considering them as critical if not the critical part of financial infrastructure.[2] To quote one recent writer, "partial reforms in the credit market alone, such as ceilings of interest rate in the informal market or disallowing credit linking may decrease efficiency, often without gains in

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2. FOR GENERAL BACKGROUND:

John Gurley and Edward S. Shaw, Money in a Theory of Finance (Washington, D.C.: Brookings Institution, 1960).

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A. N. Chandavarkar, "The Informal Financial Sector in Developing Countries: Analysis, Evidence and Policy Implications", February 13, 1986, a revised version of the resource paper prepared at the invitation of the SEACEN (Southeast Asian Central Banks) Seminar on Unorganized Money Markets, Yogjakarta, Indonesia, November 20-22, 1985.

A. N. Chandavarkar, "The Non-Institutional Financial Sector in Developing Countries: Macro-economic Implications for Savings Policies", International Symposium on the Mobilization of Personal Savings in Developing Countries, Yaounde, Cameroon, December 10-15, 1984.

Dale W. Adams, Douglas H. Graham and J. D. Von Pischke, Undermining Rural Development with Cheap Credit (Boulder, Colorado: Westview Press, 1984).

Maxwell J. Fry, Domestic Resource Mobilization and Allocation through the Financial Sector (August 15, 1986).

improving the distribution of income . . . reforms in several markets simultaneously are required as well as recognition of the importance of existing informal credit markets."[3]

2. ICMs serve important purposes such as financing otherwise unserved market segments, permitting otherwise foreclosed transactions, pioneering new and functional financial instruments. These purposes might be better served by protecting or promoting these informal markets, or by formal sector institutions studying and mimicking them. To the extent that the ends served by these markets are not desirable, it might be desirable to repress them. The DEA (Drug Enforcement Administration), in its efforts to suppress the drug trade, has moved to obstruct some of the financial transactions on which that trade depends. There typically exist a number of exploitative debt relations peonage, or as it is currently termed, bonded labor--which are prohibited by statute as contrary to

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3. Braverman and J. Luis Gausch, "Rural Credit Markets and Institutions in Developing Countries: Lessons for Policy Analysis from Practice and Modern Theory", World Development, XIV, pp. 1261-1262.

public policy—and in what are monopoly situations, limits on interest rates might be defensible.[4] What empirical material we now have suggests, however, that these undesirable market outcomes are the exceptions in the informal markets of LDCs, and that normal rates do not differ so much from formal sector rates when all transaction costs are included.

USAID Missions should be more concerned with promoting the positive functions these markets serve, since it is now generally agreed that these are far more the rule. This promotion can be done in one of four ways:

1. USAID Missions could increase their consciousness and understanding of informal financial markets and their relations with formal financial institutions. This could be done in collaboration with other institutions, and involve sponsoring surveys and research as well as disseminating research results.
2. USAID Missions could engage in policy dialogue looking to the removal of regulations that forbid or reduce the feasibility of informal market transactions. Usury laws, or those

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4. For a catalogue of such prohibited markets, see Michael Walzer's Spheres of Justice (New York: Basic Books, 1983).

that bar the collection of informal debts, mean a reduction in the availability of credit from informal sources. Thus, starting with the beginning of the century, a number of Indian states and jurisdictions in the U.S. have tried to limit the ability of agricultural creditors to recover, especially against landed security. This has typically involved dramatic decreases in credit availability in those cases where the efforts were effective.[5]

Of particular relevance may be the examining of legal restrictions on informal financing as part of the conditions precedent to particular programs. For example, if 24 percent interest rates are required--as was alleged in certain recent projects in Senegal and Bangladesh--to make them profitable to lenders, 24 percent interest rates obviously must be permitted, if informal markets are to function.[6]

3. More frequently, USAID Missions are involved with formal sector savings and

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5. Christopher John Baker, An Indian Rural Economy, 1880-1955: The Tamilnad Countryside (Delhi: Oxford University Press, 1984), pp. 302-307.

6. D. Harmon, W. Grant and B. Skapa, Midterm Evaluation of the Community and Enterprise Development Project in Senegal (Washington, D.C.: Development Alternatives, Inc., June 1987).

lending schemes which mimic or duplicate features of informal financial institutions. Group lending schemes require the same personal involvement (lending on "character"), focus on working capital finance, and lack formal procedures just like informal market lending and savings.[7]

4. In rare cases, USAID Missions fund or support transactions with formal sector institutions that indirectly refund informal markets.

   There have been proposals in Jordan to back a guarantee of bank lending to wholesalers against their trade credit to manufacturers. This is, of course, classic accounts receivable finance which is such a normal part of bank finance in many countries. In the case of India, in the past, the commercial banks not only refinanced receivables ("real bills" in the Indian jargon), but financial bills as well, particularly for the Shikarpuri or Multani indigenous lenders.

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7. Carl Liedholm and Donald Mead, Small-Scale Industries in Developing Countries: Empirical Evidence and Policy Implications (Draft, 1986).
   Thomas Timberg, "Micro Enterprise and Small Loan Funds: Anti-Poverty and Pro-Productivity", ARIES Working Paper (Washington, D.C.: Robert R. Nathan Associates, Inc., 1987).

Similar so-called "credit merchant" schemes have been tried in Malaysia and Indonesia. Fungibility guarantees, of course, that a portion of bank finance will, in any case, find its way eventually into informal channels.

In Africa, where formal sector institutions have had particular difficulties coping with rural and private clienteles in general, some recent interest has been expressed in assistance to the numerous and vigorous savings associations and ROSCAS (Rotatimg Credit Arrangements), sometimes using a PVO intermediary.[8] The administrative costs of the PVO have usually turned out to be heavy--partly because of its insistence on its non-credit functions--but the promise of such PVO intermediaries is enough to suggest further experimentation, particularly with less bureaucratic, loan centered, and

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8. Papers presented on The Role of Financial Intermediation in the Mobilization and Allocation of Household Savings in Developing Countries: Interlinks between Organized and Informal Circuits at the International Experts Meeting on Domestic Savings Mobilization through Formal and Informal Sectors: Comparative Experience in Asian and African Developing Countries, East-West Center, Honolulu, Hawaii, June 2-4, 1987.

more automatic instruments (or "types of transactions" in lay language).[9]

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9. Forthcoming ARIES Working Paper on "The Prospects for Micro Enterprise in Africa", Robert R. Nathan Associates, Inc., Washington, D.C., 1987.

A. G. CHANDAVARKAR: COMMENTS

Thank you. As I have been listening to the discussion, the thought occurred to me that it is high time we had a look at the title of the seminar, which is "The Potential for Financial Innovation". This raises the question, "Do we have a critical enough working definition of the term financial innovation?" To my mind it's a gross mistake to equate financial innovation with mere novelty or creative finance. One should define financial innovation to mean any change in institutions, instruments or markets that has an impact at the macroeconomic level of reducing the cost of financial intermediaries or at the microlevel if it improves the working efficiency of lenders or borrowers. Having said that we have to turn to another equally important question. Are the financial gaps and problems in developing countries related to the lack of innovation or to the inefficiency of existing financial systems? To my mind if one looks closely at the performance of the financial sector of developing countries the problems relate more often to what the economist calls X-efficiency or inefficiency. The fact that existing institutions and instruments are not efficiently working is not so much due to the lack of innovation. I can illustrate this with concrete examples say from Asian countries, which clearly show that many of the financial problems are unrelated to insufficient financial innovation. They are more related to gross inefficiency of the financial systems. In India, as I recall from my own experience in the Reserve Bank working parties, one of the major problems with the financing of small scale industries was quite unrelated to credit.

I know the case of a very successful small-scale manufacturer of scientific instruments in one of the Bombay suburbs. He told me that he had adequate credit but his problem was that he never got paid by the government on time for his contracts and this resulted in the fact that he could not arrange for adequate accounts receivable financing from his commercial bank. That's the type of problem that is important.

Secondly, we have problems like the multiplicity of taxes at the state and local level like the ones in India that hamper the movement of produce. This again is quite unrelated to credit. Once I told a visiting economist that India is a good example of an uncommon market because of its division into a multiplicity of tax jurisdictions that hamper economic efficiency.

Thirdly, we have problems like a quite unrealistic labor relations system, e.g., the requirement of paying bonuses even when the enterprise makes a loss. These are all problems that are unconnected with finance. I'm only saying this because one should not lose a sense of perspective and the financial expert must have an equally critical look at the possible efficiency in the existing financial system without necessarily having to innovate. Using the very useful taxonomy provided by one case paper, we can study innovations under the categories of institutions, instruments, markets and transactions and look closely, specifically, at some of the country and experience that clearly illustrate the point, which I make.

Take institutions, both in South Asia and Southeast Asia. There are many institutions that are not being used properly at the moment. I recall, for instance, there are two types of functionaries that are very good links between the formal and informal sectors in Asian countries. I refer to the institutions of guarantee brokers in the Indian subcontinent and the compradore in Southeast Asia. These functionaries work on salary plus commission basis and are employed by formal institutions to lend money to th informal sector on a guarantee basis. This system has not been popular with the regulatory authorities. This again illustrates to my mind a typical attitude of mind in the developing countries of an extremely unrealistic approach to financial problems. In India, for instance, the main factor that has led to a decline in the links between the formal and informal sectors is the reluctance of the Reserve Bank to rediscount indigenous bills for two reasons. One is the fact that the indigenous banker does not disconnect his banking and nonbanking businesses. Secondly, the fact that there is no assurance that the indigenous bill of exchange is real credit paper. To my mind these are the types of problems that should not exist if one were prepared to have a realistic approach to problems.

There is a good example of how a nationalized bank in India was called upon to discard a very innovative business. I refer to the Syndicate Bank in South India which had a very remarkably innovative scheme of running a miniature mutual fund for its depositors. After nationalization, the Reserve Bank prevailed upon it to discard its business on the grounds that it was a non-banking business! This is the type of situation that certainly does not require innovations. It requires common sense and a realistic approach to improvements in existing channels. I would hope that participants would also turn their attention, not [only] necessarily to innovation, but also the improvements of the existing financial systems.

I will also address one specific question that J. D. raised. Do we need institutions every time there is a gap? The answer is yes and no. For instance, we should explore the scope for developing multi-purpose institutions by adapting existing institutions to new objectives. We have a choice between single-purpose cooperatives and multipurpose cooperatives. The case for a new institution is strong only if there is a real gap in the economic system. For instance, many of the developing countries do not have adequate provision for insurance of credit risk. India and Malaysia are very good examples of successful operation of credit insurance. [They are] good example[s] of where [. . .] innovation[s were] necessary and desirable and [. . .] successful. The Malaysian scheme is very interesting in that the problem of moral hazard has been eliminated by making the commercial banks owners of the credit risk and guarantee scheme. I do hope that we shall also focus equal attention not only on innovations but on improvements of existing institutions and procedures. But before I conclude I must note as one who has served both in the private sector and has been an academic and also a civil servant, both domestic and international, failures are not the monopoly of either bureaucrats or the market. They are equally [. . .] prerogative[s] of academics and technocrats. Failure and success, like virtue and vice, are nobody's monopoly. Thank you.

J. D. VON PISCHKE: COMMENTS

Resources are fungible. You're in Bangladesh. It's March. It's planting time, and your daughter is getting married and you need 5,000 takas for each. Of course, when you go to [the] Grameen Bank or anybody else you're going to say [that] the 5,000 takas are inputs for planting. But [are they]? The money is fungible. So, are you really getting any value out of targeting?

If I see a guy driving away in a Mercedes, I don't know if he's used the Bank's money, his own money, or [someone else's] money to buy it. But if he said he was going to build a barn or a shed with the bank loan that he got, and if he [did] that, I don't care what money is used. The loan has been associated with something good, with what the lender wanted the borrower to do, and I don't think that's so bad. Does the borrower also use his own money for other purposes, when he could have used [it] for the barn or the car? That's something we'll never control, and I don't think we should try.

The point that brings our concerns together is the idea of confidence in the relationship. Obviously, if somebody borrows for one purpose and doesn't fulfill that purpose, if the barn is not built, then there is a real problem. The trust and confidence needed to sustain these financial transactions [are] not there. The borrower is playing a game. That's a very clear case of diversion of funds. If there is to be a relationship, there has to be enough confidence that the borrower can be trusted and that the activities the borrower is involved in are remunerative.

The question for donors is "To what extent can we really control borrower behavior?" I have just returned from Costa Rica, where I was a p of a mission from Ohio State that was collaborating with the local AID mission there. At the Banco Nacional, they were very clear in their own minds that unless you financed 100 percent of the technology that you wanted the borrower to apply—the farmer in this case—the technology would not be applied. So, they financed 100 percent of the technology and in the farm models that I looked at 40-60 percent of the loan and of the total cost was for family labor. They were financing 100 percent of the technology and felt that they had to do that in order to control, and even then they were not satisfied with the control procedures. They didn't have enough inspectors, vehicles, etc. to ensure that the farmer did exactly as the farm model specified.

Those of you with experience in agricultural lending or in agricultural development in general may have a few reservations. Is the farm model applicable to that particular farm? If not, one wouldn't want the farmer to use the technology [that has been] specified, but to use some variation that [would have been] appropriate to that farm. Our efforts to control may be sub-optimal, unless we're very sure that what we [propose] and what we want to finance is exactly what is best for that individual who is involved. Given [the] variety of markets and individuals, it's hard to get a standard package, it's hard to control and as you try to control, as Dick has suggested, your costs increase—the transaction costs for everybody increase. The borrower will incur transaction costs to deceive you and you will incur transaction costs to make sure that he doesn't. It's a losing game.

Obviously we do want to identify the activities that are worthwhile, but I'm not sure that anybody can tell us how best to do that. I don't think we have the means, but the transaction focus at least gives us a start on asking some of those questions. Jake, I don't think anybody has a problem with your overall desire that funds be used for high return purposes, for things that are socially useful, but some of the barriers to building that into project design appear to some of us to be pretty formidable.

THOMAS A. TIMBERG: COMMENTS

Are there objections? Questions?

Q. You said something early on in your presentation about the need to regulate more than one market at a time. Would you mind elaborating on that a little bit.

A. Donors learn from experience. They have a program for the commercial banks under which there is an agreement with the commercial banks that they will charge remunerative interest rates; for example, the reform that is now going in the rural credit sector in the Philippines, partially supported by AID and the World Bank. But if this is done without considering what the informal lenders are doing, what other kinds of borrowers and lenders are operating in those financial markets, the reform may have the opposite effect to that intended.

If you read people writing about finance these days, they are becoming more and more [like] plumbers. There are more and more of these water flow analogies. Money is water. I think that the point is precisely that we are dealing with a complicated system of fluid and its going back and forth through different valves and it is only few of the valves we control. If we pull down on one valve and we don't worry about the rest of the system we might flood the house.

Q. You mentioned three approaches that might be taken in the informal sector. Is there any one that you're [most] confident in than the others?

In the first place, I don't conceive of the three as exclusive, I think that they're often complementary. We are often doing all three of the things at the same time. Which one you use is often an opportunistic decision. For example, there was an interesting question and I'm sure we'll get back to it at some point asking Wes about, "what about voluntary organizations handling this kind of credit?" The answer was "well they don't seem to be this kind of thing," "it doesn't seem to be working," "it's not being done in Jordan," or "there are some voluntary organizations but they are not involved in credit." On the other hand, it seems that in Jordan trade guilds were active and they seemed to be interested in being involved in a credit project. In each country and industry, you have to look at what exists and what you can deal with. In some cases, there are voluntary organizations that can mimic informal sector behavior and can be used. In many other cases, there exists perfectly well functioning informal agents of one sort or another and it seems silly to replace them as in Jordan. They have a functioning system of trade credit. It would be better if it had more resources going through it so you take action to increase those. I have to say I have no reason to assume that this is the conclusion that the Government of Bangladesh or the Bangladesh Bank would necessarily draw from the study I described earlier but an approach like the one suggested does seem to be suggested by a number of the Bangladesh studies and as Jan knows there has in fact been some discussion with the Dhaka/AID mission about these things. That proposal suitably changed, for discounting subcontractors' bills receivable has now been taken up. These all involve providing some sort of refinancing of the top of a trading chain to drive credit down to the bottom. [See <u>Appendix A</u> for some recent examples elsewhere.]

Q1. Isn't it true that the host governments tend to be uncomfortable with the informal sector and that the donors tend to be rather awkward in dealing with it? We don't know much about how to work in this sector. And given those two sets of circumstances, where do we go from here?

Q2. I think a lot of countries would find it fairly difficult to provide additional funds to large farmers, than they would have to sharecroppers because sharecropping is felt to be "bad". Pawnbrokers, too, don't seem to have too positive an image in many places in the world so the idea of putting money in pawnbroking houses doesn't seem to be feasible. Yet, fertilizer dealers seem to have a good image and your credit merchant schemes in India, where they have as much damning evidence of money lending as anywhere else, seems to be acceptable. What determines what's acceptable and what's not? Is there any rule on that or is it entirely an empirical question that varies from country to country, from culture to culture?

A. There is no question that there are several reasons why people are unhappy about these programs of involvement. With IFM, one reason is often cultural; there is often a general [discomfortability] with for profit economic activity. Another reason is certainly professional and social distance. The people involved in informal markets are often socially disreputable. Some reasons are much more substantial in that some of these markets have been relatively exploitative. In most cases it [is] the usual question of what's available. If you have a system that is not going to have anything but sharecroppers and they're not going to have land reform, which is typically the case, it would seem sensible to try to manage the system so that the lot of the sharecroppers could be as good as possible.

Now the question is what's to be done about IFM. The answer is clearly empirical. It's clearly much more acceptable to refinance small informal groups, to refinance associations and cooperatives and so forth than it is to refinance individuals. In an argument, for example, about one group of people in Bangladesh, somebody was arguing that there's no point in providing money to Bangladesh businesses because it's just going to appear in their Swiss bank accounts tomorrow. If that is the case there's something to be said for not providing the money. I think the response has to be an empirical one.

Even with the exploitative money lender, from people who really work in the field you often get somebody who essentially says something like this: "Well, this money lender is charging an awfully high rate but we're still better off that he's providing this money at the high rate than if he weren't."

You're both correct in putting the finger on the problem that we are not comfortable with the Grameen Bank constituency. Here we are sitting in Washington, perhaps, we would like to have some relationships with that constituency to help them. The mechanism for establishing connections between us and them is not necessarily easy to establish [. . . or guaranteed to work well].

Q. Could you touch upon the relationship between informal financial market and savings mobilization? I've always read that that's a function [which] they can't provide.

A. But they do. It depends, of course, [on] what you are referring to in particular cases. There are many informal financial institutions that do both a savings mobilization role and an intermediation one. Actually, there is a fair amount of documentation of that. Especially in Africa there has been a lot of focus on it. A lot of the savings mobilization function is traditionally done by rotating credit arrangements and cooperative credit arrangements of some sort. Even money lenders and people of that sort also often take deposits, often serve various kinds of roles for their clients. You have to talk about countries and specifics. In India, these days, the public sector commercial banking system is quite extensive and [. . .] provides a considerable range of formal sector assets for savers and consequently performs a relatively larger role as informal savings mobilizer. But there are other countries where that's not the case.

JAN VAN DER VEEN : COMMENTS

I was pleased to learn that Costa Rica is in the underbelly of the United States. I didn't know where Costa Rica was. I'm afraid much of my experience, as Tom suggested, goes back to a country that we've dealt with a good deal today. Most of my examples will be drawn from Bangladesh.

I want to start off with two fairly short points and then get into some comments on the basic theme of the seminar. As many of you are aware, AID is in the throes of trying to put out a policy paper on financial markets. There are a number of issues that have not yet been fully resolved within the agency. One was touched upon here earlier this morning and that is the question of targeting. In general, the AID position will be that there has been an overreliance on targeting and that the pendulum has been a bit too heavily cast on the targeting side and that a proper balance suggests that we move away from targeting.

That's said and I think that will be a rough paraphrase of what we'll end up with. Please be advised as you all are very aware that AID as a bilateral institution finds that its policy pronouncements are generated primarily in three very different areas. The first is congressional. The Congress decrees and we, being bureaucrats more or less, obey. Congress has said we will target, end of discussion. The second is the administration. We work for an administration. The president, the head of which is elected every four years and typically has some ideological baggage that he carries with him. In this administration the ideological baggage has been quite different than that of the administration that preceded Ronald Reagan. This is the second set of forces that ends up in this instance in conflict with the congressional mandate to target. The third source is a research synthesis of experience and here AID has relied fairly heavily on the work done by Dick Meyer and others at Ohio State and on research sponsored by the World Bank as well as other research sponsored by AID and other organizations. Those three elements are somehow reconciled in a policy paper I did want to mention to you because of the discussion earlier this morning on targeting that it is not something that is easily resolved in the AID context and I submit that those of you who represent PVOs should be particularly interested in the targeting question.

The second general target that I wanted to talk about very briefly was very effectively discussed by Millard Long. It has to do with subsidies. The question of subsidies is extremely topical for AID right now in light of the $50 million earmarked for microenterprises. Millard Long ended up his discussion with a very correct analysis of the Grameen Bank situation concluding that certainly under the conditions that Grameen operates it is now using a subsidy. The question is perhaps what would Grameen do, what would Muhammad Yunus do if in fact this subsidy were withdrawn. What if he were not able to get IFAD money at 3.8 percent? What if he were required to get that money at the same rate as his competitors in the Bangladesh context? Under those circumstances would he raise interest rates, would he be able to cover his costs, would his program continue to be as successful and as effective as it has been. I think those are questions we don't have answers to but they speak to the question of subsidies.

The main point that I want to make goes back to the title of the seminar and has to do with financial innovations. We've been talking a good deal with the kinds of innovations that do not require a very heavy use of financial intermediaries, quasi-intermediaries. That is to say we're talking about systems that involve heavily the use of suppliers, to be sure financial intermediation is involved, to be sure financial intermediaries are involved, but the heart of the system that Wes Weidemann put before us has to do with suppliers credit and that is not something that normally passes in the informal sector through financial channels. That kind of issue is the one that we're concerned with here in this seminar. There are a broad range of similar kinds of activities, similar to the supplier activity that Wes so eloquently spoke about. In fact, Tom referred to an effort that he had designed in Bangladesh a few years ago, an effort that looks very much like Wes' work in Jordan. One effort that was far simpler and not fully fleshed out, primarily because AID is sponsoring that particular activity or hoping to sponsor that activity and the Bangladesh government could not agree on an appropriate interest rate. The banking structure was quite happy with a 24 percent rate as was USAID as were overwhelmingly the small manufacturers that were to be assisted.

The point is that these are schemes that do not necessarily involve suppliers as in the case of the proposal that Tom built in Bangladesh. The scheme involved engineering firms and their parents in a subcontracting relationship. There are other kinds of relationships that might well be explored in looking for alternatives or innovative ways of financing small- and microenterprises. We might take a clue from the way that the International Garment Industry operates. That too is on the order of a supplier system but there is a wrinkle. The International Garment Industry is probably a pure case of international subcontracting where the credit requirements of the manufacturers in countries--like Bangladesh--do not have to put out very much capital of their own and virtually no working capital in order to become fairly wealthy entrepreneurs and that has in fact been the case in Bangladesh. There has been a good deal written in the last five years or so about the diamond industry in Western India. This is a situation where diamonds come into the country in uncut form and polished in various places on the coast in Western India. The diamond industry is now the single largest gross earner of foreign exchange, not net earner of foreign exchange, in India. All of the polishing or the diamond cutting is done in the tiniest of workshops that you can imagine. One, two, three, sometimes 10-15 person operations, the technologies involved are not very sophisticated but very effective.

There are other kinds of activities of this sort that we might creatively look at. For example, contract farming is something which has also a dimension that very much looks to a credit relationship. If, for example, vegetables are purchased at a central point by a canner of vegetables that's a contract relationship, it is entirely likely that contract relationship involves credit. Outgrower operations involving the production of shrimp, some poultry, something of that nature are also very ingenious ways of reducing costs where central and large, often technologically very sophisticated operations, are linked to very small-scale operations that do not require a good deal of sophisticated technologies but do require some working capital. These are all different kinds of activities that we might look to that essentially are working capital financing mechanisms. They are something else as well. These mechanisms provide essential avenues for technical assistance, assistance in purchasing, above all assistance in marketing--a critical dimension that small firms are not very good at doing and where a good deal of assistance is required--and occasionally for assistance in general management of those small firms. I guess I'm suggesting that the model that we've seen here that Wes has pulled together is a model that is potentially very robust and we need to be creative in trying to find ways of extending that model if we wish to pursue that approach.

There are a couple of caveats. One has already been mentioned. I'll get to that in a second. The first of the caveats that I want to emphasize was that the linkages between formal and informal financial systems are often crucial and are not adequately taken into account. There are a lot of folks who have written on this subject lately. One aspect I've not seen anywhere in the literature and that has to do with the efforts of donors and host country governments to expand the formal financial system rapidly as it did in Bangladesh. Even that system might be woefully ineffective in what it does. It nonetheless displaces what is a far more efficient informal financial system. The short-run consequences can be disastrous. In the long run, ultimately I think the inefficiencies probably would be worked out even in Bangladesh but the short-run ones consequently once again are often very severe.

The second point again is one that Millard Long raised, "What can donors do in this area?" How do donors who are formal institutions, who have to work primarily with governments at least in the first instance, how do they program funds in a way that can assist in the informal operations that we've been talking about here, or let us say the nonfinancial institution kinds of operations. It's not easy. Tom has identified some of the ways in which a better understanding of the way the informal market operates would be helpful to agencies like AID.

I want to illustrate that point with some quick examples of what happened in Bangladesh during my short tenure there. Were we able to work closely with money lenders? Absolutely not. The political climate regarding money lenders made that absolutely impossible. Tom used the word coyote with a Spanish accent. That's the word in Latin America. You just can't do that. There's not much more to be said. Fertilizer dealers, the answer was yes, we can work with fertilizer dealers. Fertilizer dealers in Bangladesh were somehow alright but only at the retail level. AID had monstrous problems extending the kinds of credit operations that work through fertilizer dealers at the retail level, to fertilizer dealers at the wholesale levels and I rather expect that those problems would not be resolved at least not easily. Handloom cloth merchants. There were proposals to work with handloom cloth merchants in an intriguing avenue involving the way that AID provided saris and lungis, "surgical gowns," for individuals who were sterilized in the sterilization program. The point is that when we tried to open up the bidding system so that handloom merchants, who in some cases control more cloth than the largest mills in Bangladesh, we tried to open it up to bids by those handloom merchants. The government said no, and the primary reason was because of the kick-backs made by the formal sector cloth producers to appropriate people in and out of the government.

There are an awful lot of reasons why these kinds of programs might fail. There are some circumstances under which they will succeed. They are highly country-specific. I don't think that we can come up with any specific rules that define situations under which they will occur successfully but we need to explore them actively in all specific country contexts. Thank you.

NED BENNER: COMMENTS

One of the reasons I had asked Wes this morning in his excellent presentation about the Jordan program regarding the involvement of the PVO community in Jordan as a type of credit reference bureau or filter as the suppliers are going to be, is because it has to do with an interesting program that we're becoming involved in Costa Rica. I think it will give us a nice shift away from Bangladesh, Jordan and Senegal and focus on the underbelly of the United States, Latin America and the Caribbean.

For those of you who don't know about the InterAmerican Foundation, it is a Federal agency besides the Peace Corps and USAID it is one of three bilateral expressions of AID in Latin American and the Caribbean. It has existed for 15 years and has headquarters in only one part of the world and that is in Rosslyn, VA. It has a staff of about 65 people, 30 who are field staff back and forth to Latin America. Since we have no offices overseas we are literally commuters to the hemisphere. A typical representative will make about a trip every two months to his country of assignment. We are sematically assigned more geographically precisely because in a particular country a representative will come in contact with organizations or the informal type arranging from artists and fishermen, women's groups, cooperatives and farmers, etc. There is too much for any one specialist to be involved in one country. Too much of a variety of different program areas.

Our board is both private and public sector because our focus, even though we a government agency, is on supporting the private sector and not the government. The board has four from the private sector and three from the government. The government persons, whom you might be more acquainted with, would be Elliot Abrams and McCormick who is the Ambassador at the OAS and McPherson, formerly administrator at AID, which will be changing.

The budget amounts that we're talking about and I'm here in the wake of people from the World Bank and AID and we're talking small amounts of money. I'm almost an informal donor compared to the more formal donors. The InterAmerican Foundation Council on the budget each year of $25-30 million. Thirteen million of that comes from the Congress and 16 million because an arrangement we have with the InterAmerican Development Bank to tap into what is called the "Social Progress Trust Fund" which are reflows from U.S. Government money through the hemisphere and the _______ years for the alliance for progress. With a budget each year of about $25-30 million--about 20 percent of which is for overhead--we are left with approximately $20 million a year for the hemisphere for grants and grants alone. We do not make loans. We've talked about it, we discussed it and we've looked at innovative ways at how we can get away from giving grants, which we felt at times just taught people to ask for more rather than pay back and learn to deal with the usual terms and conditions of the productive enterprise which is the world of credit. We've decided that it could be much too cumbersome if you get into 150 columns of reporting that are required early or send in the U.S. Marines to take the refrigerators from Juan Jose and his family if the people did not pay back the loan. We've settled pretty much on grants, exclusively but we've gotten around it by giving grants to the intermediary organizations, PVOs who have established revolving credit programs in the country and then they will be the lenders and the collectors of the loans in the country. Because we have such limited amount of funds, we experimented with a new ideal in Costa Rica whereby in the grants that we made to a lot of base groups--fishing coops, agricultural coops, artisans associations, small business associations, etc., it was agreed in the grant agreement that we made that a portion of the agreement would be paid back to a third party to be named by the foundation. In our search for what that third party should be the suggestion of one of our private sector board members was that instead of paying it back usual and the easy way to a PVO, whether it be _______ in a country of the federation of cooperations a second level federation, you in the foundation was an experimental one and pay it back to a commercial bank, have the commercial be the repayment third party for some of your guarantees. That bank similar to what we say in the case of Jordan would have a joint fund and begin lending the money to the small business people in a given area. The idea being not only to graduate up or integrate into the commercial banks the nonformal types but also to start to teach the bankers themselves not a new theme at all, start to teach the bankers about how non-traditional types, informal sector types can become creditworthy and play in the big leagues of some of the others. This is a program that we are now initiating in Costa Rica although I must admit that when the Board member first said it, I was quite skeptical but since he was a Board member I was not about to tell him no at the outset and we did explore and I think we hit bingo on our first encounter, at least this is our hope having met earlier this month in Costa Rica with ______ which has received AID support and which has as a general manager Bill Phelps, from Michigan who was formally employed by AID and formally a Peace Corps staff member. On a personal level the sort of a love in from the outset on a professional level he has already been involved as a member of the Board of Directors of an organization called AVONSE, which is the ITEC counterpart in Costa Rica. He's already involved in a program to try to look not at the suppliers as a filter as was presented in the Jordan process but AVONSE would be his credit reference bureau and small business people in the San Jose area who have been involved with ITEC and AVONSE in their credit program, AVONSE being a PVO, if they're what they call a ___________, repayment loan, repayment record is good they will be recommended by AVONSE to graduate into the commercial loan fund that will now be supplied in part by IAF money repayments from the grantees that I eluded to earlier, and at some counterpart funds from the _________ group. It is our hope that we will get a bigger bang for our buck by having some of the reflows flow back to _____ then recommended by the ITEC group their be able to integrate into the bank for the first time and begin receiving credits from _____ and graduate into the direct funds of ________'s irregular credit person. We're talking maybe $200-300,000 to _____ over the next three or four years as it is repaid by the grantees that received it and our expectation is that with the help of this PVO and remember that the PVOs ten years ago weren't around that much in Latin America and many weren't involved or didn't have a longer kind of experience with credit to small enterprise and they now do exist as a type of filter that may in concert with a donor agency or commercial bank be able to provide us with a viable mechanism whereby people can now move away from the development agencies and into the commercial banks that exist in the country or at least that's our hope as we watch this experiment unfold. Any questions? It's very new and who knows what will happen.

How does the commercial bank defray its costs of lending the money? Well in part it has to do with what you called earlier this more a reform of transaction costs. The transaction costs are being passed over to ITEC ____ and that they are already doing some of the leg work for us or for Corfesa in terms of determining which groups are more creditworthy than others, not by character accept the character depending on how well they've repaid previous loans and ITEC ________ down there is making over 100,000 loans in the San Jose area, very small loans and he is already identified several that he feels could move on now to commercial banks.

MILLARD LONG: COMMENTS

I'm sorry that I wasn't able to be here this morning but over the weekend I'm going to be leaving for Nepal to do a financial sector study of Nepal, which I presume from what I've been reading about the country will involve a lot of lending to small enterprises and to agriculture so I'm not completely buried in the World Bank. Occasionally I raise my head even to look at small enterprise borrowing. I'm sure it's been mentioned at this conference that Mike Farbman of AID and with Jakey we will this summer be sponsoring a conference ourselves on microenterprises of which credit will feature very prominently.

I did read and tried to figure out what their common theme was. It seems to be that this really was a group of papers dealing with the issues of financial technology. The traditional large scale financial institution finds it it very difficult to make loans to small enterprises because of the cost of intermediation and the risks involved in that kind of lending. What two of the papers have in common and what runs through the theme of the other two is that we can innovate in such a way as to make it possible for the financing, if not the institution itself, the larger financial intermediaries to reach the small borrower. I agree with what J.D. Von Pischke has to say that to do this would require a very careful analysis at the level of the transaction to understand enough about what's going on at that level to build up the kinds of programs, I won't say necessarily the intermediaries, but the kinds of programs to serve the small borrower. Too often we've started at the level of the institution and thought that we would innovate, we'll create a financial and agricultural credit institution and presume that having an agricultural credit institution it would serve small borrowers when we didn't understand enough of the process and the needs of the clients to have a good program. We must think about innovations, building up from that transactional level, and see if we car develop programs out of the Grameen Bank or the suppliers credit program talked about for Jordan that can adequately serve this small borrower group and yet leave a reasonably healthy financial intermediary.

Let me look a little bit at a different level and that is at the transactional level of the microenterprise and make a few remarks about how I visualize the problems and the services needed by the small entity. First, I would like to make the observation that everywhere, this includes the United States, the primary source of finance for very small enterprises is non-institutional. I would even say that it even isn't the formal financial lender that Tom Timberg is talking about because Tom's are professional business people making the loans even though they are not financial intermediaries. I think the main source of financing for small enterprises is really household savings to begin with, family and friends, and predominantly for ongoing institutions, retained earnings. These institutions only occasionally tap sources other those when they go to the kinds of sources that Tom talks about which he calls the informal financial markets.

As for most of small enterprises, they don't get investment financing, long-term investment financing, when they borrow. They are after seasonal short-term or short-term credit often at a seasonal nature. If we're talking primarily about agriculture then that's what the borrowing would be, of a seasonal nature. There are a number of things that follow from that. First it follows that when they are not borrowing and for most institutions for most of the microenterprises that would mean a very large part of the year, they are in fact in financial surplus and that gets to a point that J.D. often makes. When we're trying to serve microenterprises, whether they be agriculture or non-agricultural enterprises what they really need is a repository for their excess funds rather than a source for their borrowing. When we're thinking of the transactional level as J.D. puts it, we must be thinking about providing them depository services as well as credit services. There are some other things that follow from this as well.

One of the things is that despite the numbers that we often hear about how expensive it is to borrow from the informal sector, usually quoted to us in terms of annual interest rates or even in terms of monthly interest rates as 3 percent or 4 percent per month or 45 or 50 percent per year, we must understand that those loans are likely to be outstanding only for a very short period--three months. If it's a loan in agriculture, it might be quite common toward the end of the growing season before harvest when the family has run out of its own funds, its own liquidity. Its own liquidity has been transformed into works in progress, that is crops in the field and it needs to borrow to finance its expenditures until the crop comes in. Then it borrows and if it pays 3-4 percent per month, fine, but it only borrows for three months. If you work it out as a part of their total expenses those interest rates turn out to be a small part of total expenses.

Another thing that comes up if you think about seasonal needs is that you ought to think about the person who deals with the farmer, the business person who deals with the farmers because his credit needs are seasonal, too. Probably he is a mirror image of the agriculturalist and this I think would also apply to small enterprises, that is, the guy who buys the crop from the farmer. As the businessman sells the crop during the year, his liquidity goes up, reaches a peak probably just before harvest time when all of what he's bought is sold. Then he buys the crop from the farmer, the farmer no longer needs the liquidity but the guy who is doing the purchasing does. You have a complementarity over the year between the business man, the crop purchaser, and the agriculturalist, which leads to one of the basic economic reasons why so much of this borrowing is done from the informal financial sector. There is a pool of liquidity in the country-side that is moving back and forth between the business community and the agriculturalist or between one kind of small enterprise and another kind of small enterprise as the seasonal demand for that credit takes place. That, coupled with the lack of information that the formal financial institutions has, its high operating cost, and relatively poor repayment record for most of these financial institutions gives us the basis for the advantages that the informal sector has in dealing with these small borrowers over the formal financial institutions.

Looking at these questions of how we innovate, Tom's answer to that question is "Let's think about this informal financial market, these informal lenders and see if we can somehow take away the constraints that are impeding their operations and perhaps move to a slight promotional role." Because of the advantages the informal sector has in dealing with the credit needs of these small borrowers lets try in some sense to promote that. Weidemann's paper is another step in this direction. It suggests a particular mechanism for a half-way position. Suppliers do indeed borrow, larger suppliers do indeed have access to institutions, but he wants to increase their access to institutions, and is suggesting a specific program to increase their access to institutions. Not to bring the institutions directly into contact with small-scale borrowing because that seems to be too expensive but bring them into contact with the supplier who then himself is in touch with the small borrower.

Richard Meyer's paper deals with the Grameen Bank. That is an example of innovation where people have gone as far as they can to develope a program from the transactional level that is a program where an institution itself is designed to cope with the problem of the small borrower. I tried to use the figures in your paper to do some calculations and it seems to me that I came up with numbers that suggest that program is quite expensive. If I take your figures and presume that there are no losses but they are only able to lend out the money. They are using one-half of their money to put into deposits, which earn a surplus with which they then in some sense cross-subsidize the lending program. I worked it out that the costs of this program are around 20 percent of the money loaned (4 percent in losses and 16 percent in administrative costs). That means that it is an expensive program. Even one that is well-designed as this one in going as far as it can to meet the demands of the small sector does in effect require the kind of subsidy of cheap financing. Without saying that there is anything wrong with this, I am left with the feeling that the two papers by Timberg and Weidemann say look the institutions cannot deal directly with this size borrower without some kind of subsidy. Even in the best program that we can find, there is implicitly some subsidy there. That means it's expensive to go nationwide with a program like these. If you really are trying to reach the small borrower we will continue to have to innovate in a way that probably means that the institution itself will not be able to deal directly with the small borrower.