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SEMINAR ON INFORMAL FINANCIAL MARKETS IN DEVELOPMENT

INFORMAL FINANCIAL MARKETS IN SENEGAL AND ZAIRE

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Robert A. Flammang

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Background

"Informal" means casual, ordinary, without ceremony. Informal activity is direct, efficient. It is goal-oriented; means are secondary. Results are what count.

So it is with informal financial markets. They are direct, efficient, and results-oriented. Their very lack of form or structure also makes them hard to define, describe, or measure. Therein lies their fascination on one hand and their capacity to frustrate on the other. I should know.

In June 1988 an interdisciplinary study group composed of myself (an economist), anthropologist Gordon Appleby, and small business finance specialist Jan-Hendrick van Leeuwen was sent to Senegal and Zaire by the Agency for International Development to gather impressions of the nature and importance of informal financial markets in those countries. It was hoped that a deeper understanding of them might help A.I.D. decide whether assistance to them could promote the resource reallocation necessary to accelerate economic growth.

We also paid some attention to formal financial markets, though this was secondary. For one thing, A.I.D. is currently supporting formal market restructuring efforts in both countries. But we really included formal finance to provide contrast with informal financial markets and to see what linkages might exist between the two. The very narrowness and weakness of formal financial markets, in fact, did help highlight the relative dominance and efficiency of informal financial markets in both countries.

We spent relatively short periods in each country. With little prior information available, we approached these markets informally, essentially allowing the subject to shape our methodology. Since the study was only exploratory, we generated few new statistics and we made no claims regarding scientific validity. We hoped our observations would simply provide an inductive platform for later and more rigorous study, should that prove desirable.

Senegal and Zaire were selected for several reasons. Both have suffered economic stagnation or decline for decades but are significantly different: Senegal is small, has a low inflation rate and moderately low income, while Zaire is larger, has accelerating inflation and a very low income.

We used central place theory to locate places with higher savings and investment potential. Central place theory assumes that the location of market centers is determined by the local pattern of demand, and that censusing these centers provides a sense of their income levels, savings potential, and income distribution. This method has proved to be surprisingly accurate when checked by more complete investigation later.

Once we selected the market centers for study, we interviewed small business people to determine their savings patterns and the sources of their capital for startup, operation, and expansion. We also interviewed bank managers, managers of semiformal financial intermediaries, and informal sector tontine managers and members. The impressions we gathered from this approach formed the basis for our report.

The Size of the Informal Sector

The informal sector, which we defined as that portion of economic activity mainly outside the domain of the formal legal system and government, is very large in both countries. We believe that at least 60 percent of the population in Senegal and 85 percent of the population in Zaire earn their livings primarily in this sector. Information on income or full-time employment generated by the informal sector was not available, but clearly most people participate in informal sectors part of the time. Informal sector activities touch everyone.

The Importance of Informal Financial Markets

The importance of informal sector financial markets appeared to us to parallel that of informal sectors, if not exceed them. Informal sector firms are financed mainly by individuals and financial entities within the informal sector, and informal savings are also largely invested in it. Interestingly, the relative importance of women, both as savers and investors, is visibly greater in informal financial markets than in formal ones in both Senegal and Zaire.

Macroeconomic Policy Impact

We also concluded that macroeconomic policies have major impacts on informal as well as formal sector activities. In fact, their impact may be strongest on the informal sector. In Senegal, tight monetary and fiscal policies appeared to reduce liquidity in remote rural areas more than in major cities, perhaps because cutbacks in parastatal activities have been more severe in those regions. In Zaire, inflationary macroeconomic policies appeared to have a similar impact: compared to major cities, prices and incomes seemed to lag in outlying regions where informal sectors are more predominant. We were convinced by what we saw that structural adjustment policies are not synonymous with help for the poor. Indeed, the reverse may more often be true. Much depends on where and how macroeconomic adjustments are made.

The Nature of Formal Financial Markets

In Senegal, the government-dominated formal financial system is retrenching with IMF and international debtor support. It has been plagued with poor management, high operating costs, poor earnings, and a long series of government-ordered debt forgivenesses on farm loans. All of these are indicators of poor financial condition.[1]

The financial austerity program had brought inflation to under 4 percent at the time of our visit, but it had also dried up credit supplies for everything but short-term commercial purposes. Agriculture had previously received substantial credits, but cutbacks of debt-ridden parastatals supplying it has left the sector with little but informal credit supplied mainly by family and friends.

Moneylenders, an important source of farm credit before independence, have not reappeared in sufficient number to make up for the disappearance of the parastatals in Senegal, and a new agricultural bank has reached only a claimed 30 percent of the country's farmers. Too, its collection efforts had been and doubtless still are hampered by memories of debt forgivenesses by

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1. Dale W Adams, "The Conundrum of Successful Credit Projects in Floundering Rural Financial Markets, Economic Development and Cultural Change, Vol. 36, No. 2, January 1988, p. 360.

predecessors. The upshot is that rural incomes and currency supplies have fallen and it appears that both formal and informal financial markets have suffered accordingly.

The formal financial system in Zaire basically finances the national government, international commerce, and domestic commerce, in that order. Most loans are short-term, but are routinely renewed for the national government, converting them into what are effectively long-term loans. Many loans have a concessional component, another indicator of lender nonviability and systemic weakness.[2]

Severe inflation and general economic uncertainty in Zaire are reinforcing traditional financial intermediary preferences for commercial lending. Inflation is also seriously eroding the capital position of formal intermediaries. As in Senegal, their management is poor, they are overstaffed and highly political, most loans are in default, and real earnings prospects are bleak. Banks and other formal entities have no interest in attracting deposits or in lending to smaller businesses or consumers. Outlying areas, whose price increases and real incomes lag behind Kinshasa's, appear particularly starved for real liquidity and especially vulnerable to inflation-induced declines in real income.

Semiformal Financial Markets

Senegal lacks semiformal financial markets, primarily because of legal restrictions on their formation and operation. But the demand for their services, especially as safekeeping agencies, is great.

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2. Ibid., pp. 360-2.

Zaire's semiformal financial markets are dominated by cooperatives, which lend mainly to the national government by purchasing treasury bills; the already-small share of commercial and personal loans in the country's total financial system is shrinking further in relative importance. Coops do receive substantial deposits from members, mainly for safekeeping. Where they exist, these coops are well located and accessible to small urban savers, but they pay heavily negative real interest rates, are poorly supervised and suffer from frequent fraud and theft. Inflation is also severely eroding their capital bases.

Informal Financial Markets

In Senegal, we found informal financial markets to be most important (in absolute terms) in urban areas, where population density, incomes, and savings are greatest. Money savings in these markets are surprisingly large and are typically held as cash rather than deposits. Savers typically accumulate funds through tontines or by means of periodic deposits with trusted individuals in their villages or neighborhoods. Collective savings, such as caisses villageoises, are probably most available for development purposes; a small proportion of these are regularly deposited in banks. Savers, and especially young men from northern and eastern Senegal, also frequently accumulate funds by working in formal sectors in other African countries or in Europe; these savings often fund the building of mosques or the acquisition of wives.

Most of the individual and group savings in Senegal are eventually used for "consumption"--that is, they are used to purchase durable goods, are held to carry the family through the "hungry season" (the pre-harvest period) or are spent on religious celebrations. Some savings are also lent to other family members to tide them over hungry seasons or other emergency periods.

Some Senegalese savings, however, do finance inventories or setup costs for small enterprises owned by friends or family members. For example, the Senegalese often form temporary partnerships to start businesses, with the primary partner buying out the others later; the cost of these loans obviously depends on business profitability. Family and friend loans are always interest-free, but interest rates on supplier credits typically range from zero to 30 percent annually. Loans from moneylenders (merchants and marabouts, typically) usually cost between 50 and 100 percent annually. These loans are normally used to finance emergencies.

Zaire's informal financial markets follow much the same pattern. The country's savings are surprisingly large, especially in light of the 180 percent inflation rate at the time of our visit. They are frequently accumulated by means of tontines, and generally in urban areas. As in Senegal, most loans are to family members or friends for "consumption"--for durable goods in urban areas and to meet hungry season expenses of poorer relatives and friends in rural areas. Occasionally savers make very short-term loans to family or friends for business purposes, usually to restock inventories. Also as in Senegal, longer-term "loans" may take the form of partnerships between friends or family members to start a business, with the primary partner buying out the others after a year or so.

Loans to family and friends in Zaire are always interest-free in a formal sense, but they do include expectations of reciprocity later if the lender faces a need. Moneylender loans, usually from merchants or salaried people, typically cost up to 70 percent per month, but default rates are high and on casual observation it appears that the net return to lenders after inflation and risk are adjusted for is far below the nominal rate.

As I noted earlier, inflation has damaged both formal and informal financial markets in Zaire, especially in regions other than Kinshasa whose price increases lag behind the capital's. Poor transportation and communication facilities also impede them, since person-to-person dealings are required in financial markets as much as (or more than) in other markets.

Linkages Between Formal and Informal Financial Markets

Linkages between formal and informal financial markets in Senegal do exist. Tontine proceeds, proceeds from market collectors, and village collective savings occasionally are put in banks, but the amounts appear small and banks, which are more dependent upon the government and donors for loanable funds, show little interest in attracting them. But the banks do offer informal-sector savers safekeeping facilities, and this security is very important to these savers.

Formal financial intermediaries also indirectly assist informal activities, primarily by channeling remittances from abroad and by supplying wholesaler credits to retailers and artisans. In Senegal, however, the amounts are more significant than in Zaire, especially in the northern and eastern region (for remittances) and in larger market centers (for wholesaler credits).

In Zaire there are similar linkages, although they appear to be both stronger overall and <u>less</u> beneficial to both financial markets than in Senegal. Some savings of people who operate primarily in the informal sector are deposited in semiformal coop accounts, most of which is onlent to the national government through coop purchases of treasury bills. In this case the informal market helps finance formal sector activity, much of it conspicuous public and private consumption in Kinshasa. Depositors receive safekeeping services from the coops, but also lose substantially as inflation erodes their real incomes and the value of their money holdings. This is the major link, and it clearly benefits the government and the formal sector of the economy at the expense of small informal-sector savers, who lose both income and capital.

In the opposite direction, there are some extensions of short-term credits by Zairian formal-sector wholesalers and suppliers to their informal-sector clients, mostly small merchants and artisans. These are not large, and are quickly disappearing.

Formal and informal financial markets appear to display different comparative advantages wherever they occur. The formal market provides a relatively high degree of security and structure to savers and borrowers, while informal markets provide more flexibility and, for business loans, higher rates of return.

Shortages of Liquidity

As I noted earlier, Senegalese inflation rates have been lowered to under 4 percent annually, but the impact of IMF-encouraged austerity measures has been uneven. The most severe effects appear to have been in the countryside, where informal financial markets are relatively most important, but are not as articulated nor intermediation as developed as in the cities. In relatively remote parts of the country, the scarcity of currency is reportedly worse, relative to prices, than it was two to three years ago, and considerably worse than it was before independence. In fact, bank branches which existed two decades ago have disappeared in some regional centers, and only now is there discussion of reopening some of them.

This currency scarcity in Senegal hampers market development in general by reducing the number of transactions, specialization in production, and thus income growth. It also reduces the degree of articulation and the risk-absorptive capacity of informal financial markets even more than in formal markets, primarily because they make relatively heavier use of currency.

In Zaire, the accelerating rate of inflation also appears to be disrupting informal financial market development more than the formal by forcing people, especially rural dwellers on the fringes of the money economy, increasingly into barter and subsistence activity. High inflation appears to be discouraging money savings among those sensitive to real rates of return and and encouraging investment in largely unproductive outlets such as urban real estate and inventory speculation.

Even though Zaire's money supply is increasing rapidly and one might reasonably expect the country to be "awash in liquidity," inflation actually appears to us to contribute to rural illiquidity because of its uneven rate of transmission. Illiquidity is especially acute in regions whose "export" incomes (to other parts of the country) rise more slowly than their "import" incomes, which includes virtually all regions except Kinshasa. High inflation rates also appear to contribute to a general breakdown of trust; few Zairians trust anyone other than their own families and friends. And without this trust, risks cannot be packaged and shifted to encourage innovation, and economic growth is dampened accordingly.

At present the desire for economic security appears to be the primary motivation for saving in both Senegal and Zaire. Savers wish to safeguard their funds from theft and from predatory relatives seeking loans, as well as to accumulate funds to meet family emergencies.

The Question of Sustainability

Formal financial markets in Senegal and Zaire, compared to their informal counterparts, appear fairly structured and well defined, with relatively high fixed costs and low variable costs. Their geographic spread is quite large. With all their shortcomings, they still seem to provide more security and more scale economies than informal markets do. Behavior in these markets is quite standardized and conformist; deviance and innovation do not appear to be appreciated. Personal differences between clients tend to be minimized; relatively mechanical and impersonal evaluation of loan customers and investment opportunities appear to be the norm. Formal sector transactions are comparatively large and are repeated at regular intervals. The focus of trust appears to be on the system as a whole.

In contrast, informal financial markets in these countries appear to be comparatively flexible, poorly defined, and have low or no fixed costs. They are highly localized and provide relatively little security or economies of scale. The behavior of participants is highly individual and transactions vary with the people involved; these markets thus appeared to be very flexible and adaptable. Transactions tend to be relatively small, somewhat irregular, and often involve goods as well as money. The focus of trust appears to be on the individuals involved in the transactions rather than on the system itself.

I believe that these different market characteristics help explain why many forms of informal finance are sustainable while many, if not most, formal finance programs are transitory. Informal financial markets are flexible and highly specific. This enables them to involve many different individuals and many different purposes. Tontines are created for particular people, purposes, and time periods. Deposits of savings for safekeeping may be with a merchant at one time and with a reliable relative at another. Loans may come from a cousin today and a moneylender tomorrow, usually for relatively short terms. The "glue" which holds these markets together appear to be essentially the personal knowledge and trust each participant has of his or her partner in the transaction.

Formal financial arrangements, in contrast, appear to be more organized, structured, and rigid. Formal loans tend to be relatively concentrated with respect to type, term, and purpose to realize scale economies. If crops fail and if most formal sector loans are crop loans, the formal sector is more easily threatened with collapse. If trust evaporates, reserves may be inadequate to meet withdrawal demands. Longer term loans make it more likely that borrowers may be caught illiquid. The very form of formal arrangements appear to suit them to stable economic surroundings; if major unexpected changes occur, they may well lack the flexibility needed to survive.

After all, the strong suit of formal finance is its ability to multiply loans on a fractional reserve base. General uncertainty necessarily limits both the expansion of formal financial markets <u>and</u> their ability to withstand shocks should they occur.

Contact with the Poor

Why can informal finance deal with the poor while formal financial markets generally cannot? To me, the answer again lies in the flexibility of informal financial markets, which respond especially well to individualized needs, compared with the greater rigidity of formal financial markets, which respond better to standardized patterns of demand.

The poor are, by definition, subsisters. To subsist in a frequently-changing environment, a person must be flexible above all else. Contrary to what many academicians have supposed in the past, localized production and consumption in developing countries is both highly fluid and experimental. Kitchen gardens are small agricultural experiment stations. Sons and daughters of farm families routinely leave, work in nearby regions or distant cities, and bring back both money and information about alternate ways of making a living. When times are especially difficult, fathers may leave and do the same thing. In Senegal in particular, as many as one-third of the young men from a village may be working in Europe, in a richer African country, or in the capital cities.

In cities, the subsisters are equally flexible. While they may live in neighborhoods populated largely by people from their own agricultural region or from their own tribe, they will in essence "farm the labor market" in these cities and produce whatever can be sold. Virtually all of the urban poor are relatively unspecialized, especially the men: the women may stick to sewing or cooking or doing laundry because these activities permit them to stay relatively close to home, but the men range far and may fix tires, sell or make handicrafts, run errands for the rich, drive taxis, load and unload trucks or boats, or whatever.

The upshot is that when the poor have cash savings, they will place it for safekeeping with someone nearby who is trusted and has lockable facilities--a merchant, some nuns, or an older relative or friend who has accumulated some property. This person usually will be someone who can keep a secret--in Senegal and Zaire, at least, many cash savers seem to have a strong interest in concealing the fact that they have savings because other relatives and friends may tap them for a loan otherwise, and they literally cannot refuse such loans if they wish to remain members of their groups "in good standing."

If there seems to be no one who can be trusted with cash around, they will invest it in relatively durable goods which can easily be sold. Similarly, when they need a loan, they will go first to nearby relatives and friends, then to merchants they deal with frequently (or religious groups or leaders in some cases), and finally to richer merchants (often expatriates) who may also be moneylenders who charge interest.

Personal relationships thus govern financial dealings in informal financial markets in Senegal and Zaire. Transactions costs are low because personal knowledge substitutes for formal research on who can be trusted and with what, and because extensive travel or special levels of literacy are not required. Also, these transactions are typically undocumented, so formal-sector taxes or fees, if any, are easily bypassed.

In contrast, formal financial markets in Senegal and Zaire require a form of "membership," i.e. there are "entry requirements" for participants in these markets. Members must "own" something identifiable, something that has "form" like a bank account, a regular job, a leadership position within an identifiable group, a licensed and taxpaying business, or some other form of property. They must wear shoes, be suitably dressed, have an acceptable address, be somewhat literate, be regular in their habits, and often they must be members of a certain tribe or speak a certain language with a certain accent. As the term "formal" implies, there must be an identifiable pattern or form which suggests regularity, order, structure, specialization, and the like. This permits economies of scale and a degree of repetition which in time can develop into a sense of trust and security.

In sum, informal financial markets in Senegal and Zaire appear to reach the poor because transactions can be individualized. The poor lack significant property which might serve as a cushion allowing them to live relatively constant lives with regular income and regular consumption; instead, they must be prepared to scramble and take advantage of whatever opportunities may arise.

Formal financial markets in these countries fail to reach the poor because they are simply too structured to deal with property-deficient clients on an individual basis. Formal financial institutions survive by being able to deal with people who are basically alike, who conform sufficiently to permit mass processing of deposit, withdrawal, and loan transactions. For people to be capable of behaving in such regular fashion, they must have a cushion of property or status to fall back on. They must also be relatively specialized, since specialized behavior is repetitive behavior which translates into frequent performance of routine transactions. These offer economies of scale while informal financial markets offer flexibility.

Lessons from Informal (and Formal) Financial Markets

What can be learned from informal finance that might allow formal finance programs to operate more equitably and efficiently?

If each type of financial market can learn something from its counterpart, an economy should become better integrated and more flexible at the same time. Better integration should yield more equity and more flexibility should spell greater dynamic efficiency. The key to these changes appear to me to lie in mutual humility and mutual respect.

Can policy contribute to mutual humility and mutual respect? I submit that it can, if it can promote broader knowledge and experience on the part of participants in each financial market of what the other does well and what it does poorly.

Let us consider, first, what formal financial markets lack and informal financial markets have in Senegal and Zaire. From my perspective, it is obviously flexibility. Formal financial markets need more freedom to, more discretion, fewer restrictions. To some extent, this is contrary to what has become their basic nature--the capacity to process large volumes of transactions for conformist members. Yet some formal financial institutions have shown themselves capable of outreach activities, especially in Senegal.

For example, the Caisse National de Credit Agricole de Senegal (CNCAS), the new agricultural credit bank mentioned earlier, has demonstrated that aggressive field agents who are willing to get out of the office and deal with farmers in the field may have a significant positive impact.[3] It is true that outreach activities like this can generate internal stresses between bank traditionalists and bank outreach people, but if experience can demonstrate that such outreach need not be competitive with, but supplemental to ordinary bank activities, these tensions should ease.

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3. Agency for International Development, Informal Financial Markets: Senegal and Zaire (Washington, D.C., 1989), pp. 21-2 and p. 33.

Similarly, more innovative formal financial institutions in Senegal and Zaire may be able to station agents in daily or weekly marketplaces to offer safekeeping services (and eventually loans) to tontine managers or individual savers in those places, especially when local teachers or salaried officials get their paychecks or when farmers are selling livestock or crops. Informal sector savers in Senegal have voiced strong desires for better safekeeping services.[4] Also, the recent rapid growth of semiformal financial cooperatives in Zaire in the face of strongly negative real interest rates is further evidence of both the desire for safekeeping services and the need for loans.[5]

On the other hand, formal-sector bank-sponsored training programs for employees of credit unions, cooperatives, and mature tontines on the verge of becoming lending institutions could allow formal financial institutions to assist informal and semiformal financial markets. After all, the great weakness (as well as strength) of informal financial entities in these two countries is their unstructuredness, which makes them especially susceptible to managers who abscond with client funds. Formal financial institutions have tighter controls and generally better security than informal entities.

Informal financial markets in Senegal and Zaire can also benefit substantially from improved definition and enforcement of property rights, something formal financial institutions already understand. This could not only improve loan access for many poorer producers, but increase property values for all property owners, both formal and informal. A dramatic example of this is the capital gains received by American property owners when the weak and insecure Articles of Confederation were replaced by the relatively secure and

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4. Ibid., pp. 46-7.

5. Ibid., p. 58 and pp. 62-7.

structured Constitution in 1789.[6] Improving the security of property and persons can have dramatic positive effects on both efficiency and equitability.

The Role of Donors

If my analysis so far is correct, we may say something useful, but perhaps unwelcome, about the potential role of donors in helping to cross-fertilize formal and informal financial markets.

Informal financing arrangements in Senegal and Zaire are delicate, voluntary, and highly individualized. Donor agencies are large and highly structured, with many often conflicting constituencies and agendas. Should we expect elephants to be good at picking daisies? I think not; but that does not mean that donors cannot be helpful. Perhaps they can provide safety cushions for those just learning to pick daisies and help develop stronger daisies as well.

I have stressed the importance of security to participants in informal financial markets. Large entities like donors have a comparative advantage in providing security. They have some leverage in promoting legal changes which can both enrich and invigorate private sectors, both formal and informal. They can provide guarantee funds which, with proper controls, can help generate the trust on which financial markets rest and innovate the types of securities which are their stocks-in-trade. They can fund experiments with outreach activities and training courses for both formal and informal financial functionaries.

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6. See, especially, Chapters 6 and 8 of Stanley Lebergott's The Americans: An Economic Record (New York: W. W. Norton & Company, 1984).

Most of these are not activities which can absorb a great deal of money, at least initially. It is true that they do have the potential for helping large numbers of people, most of whom are poor. But they also have the potential for damaging existing "trust structures," which are delicate by their very nature. Overweening enthusiasm for the latest "point of insertion" would likely do more harm than good. My counsel to donors would be to proceed experimentally, cautiously and on a small scale, to expect many failures, and to refrain from supporting winners once they have proved to be winners. The last thing any donor agency should want is to interfere with a recipient's long-term economic independence. This can only damage both donor and recipient in the long run.