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A Report to
The Government of Honduras
and
The United States Agency for International Development

TECHNICAL REPORT
HONDURAS-INFORMAL FINANCIAL MARKETS ASSESSMENT

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December, 1990

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ABSTRACT

Technical Report Honduras Informal Financial Markets Assessments

by

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Informal financial markets (IFMs) were widely discussed and poorly understood in Honduras, as well as many other developing countries, at the time this report was written. The study investigates the individuals and institutions that function as part of IFMs in Honduras in terms of their financial services, the costs of these services, and the clients served. It examines the terms, users, conditions and uses of lending; alternative financing methods (private placements, supplier and buyer credits, remittances); the regulatory framework of different types of informal financial agents; and the relationship between formal financial institutions and informal lenders.

The study finds that many borrowers and lenders choose IFMs over formal financial institutions for several reasons as follows:

- access to loans for informal sector agents who do not meet all the banking requirements (character, collateral, and cash flow) of the formal sector;
- lower borrower transaction costs such as lower time and travel costs;
- timeliness of informal lending whereby the fast, simple loan application and disbursement process lets the borrower know quickly if the loan is approved and, if approved, the borrower receives the money rapidly;
- flexibility in the wide variety of guarantees that can be accepted for a loan;
- flexibility in the loan size, duration and interest rate charged according to borrower needs; and
- longer hours and friendlier, more convenient services.

Savers with funds for "deposit" appear to choose IFMs primarily because of the higher interest rates that can be earned on these funds.

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Honduras

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December, 1990

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I. Introduction

Informal Financial Markets (IFMs) are widely discussed and poorly understood at the present time in Honduras as well as many other developing countries. An important reason for this lack of understanding of IFMs is the wide variety of phenomena that can be included in this sector and the consequent difficulty that researchers have in defining and studying IFMs. IFMs may be defined by market transactions involving the creation of financial assets and liabilities contracted without the intermediation of formal financial institutions. These financial assets and liabilities do not appear on the books of formal financial institutions. For this reason, an important characteristic of IFMs is that such transactions escape the review and control of monetary authorities such as central banks and other regulatory agencies, whereas formal financial institutions are subject to these controls. This freedom from central bank regulation is the characteristic most frequently mentioned as the essential difference between informal financial markets and the formal financial market.

However, IFMs are not totally exempt from regulation. In many developing countries, IFMs are subject to such regulation as that found in the commercial code governing contracts, promissory notes and mortgages but are not subject to monetary regulations such as interest rate controls, reserve requirements, and reporting and audit requirements. Honduras presents a unique case because moneylenders there are subject to interest rate controls and loan reporting requirements (to be discussed later) that the author has not encountered in any other country.

A. Methodology

The purpose of the present paper is to investigate the individuals and institutions that function as part of IFMs in Honduras in terms of their financial services, costs of these services, and the clients served. The terms, users, conditions and uses of lending, alternative financing methods (private placements, supplier and buyer credits, remittances) the regulatory framework of different types of informal financial agents and the relationship between formal financial institutions and informal lenders are investigated. Case study interviews with individuals, firms, researchers and policy makers in the private and public sector were completed in August of 1990. This includes a wide variety of individuals, firms and institutions that undertake a significant amount of financial activity in Honduras. Some of these are moneylenders, pawnbrokers, friends and relatives, rotating savings and credit associations, and merchants of all kinds (input suppliers, traders, millers and other processors of agricultural commodities, retailers and wholesalers). In addition,

credit unions, agricultural cooperatives, and non-government organizations (NGOs) are included in this report as part of the informal sector. Many firms and institutions may be considered as informal in terms of their financial market activity, while at the same time they function as formal institutions for some of their other business activities.

B. The Importance of IFMs: Recent Findings

IFMs are an important and increasing source of financial intermediation in Honduras; however, no firm estimate of the size of this market can be made because of the problems of defining what to include in the sector, the complexity of the sector and the fact that information on the amount of activity is difficult to obtain from many of the participants. In countries such as Bolivia and Peru, IFMs are estimated to account for the bulk of financial activity (Ladman, Medina, and Soto). While it is likely that IFMs are not as dominant in Honduras as in those countries, it is probable that in aggregate, their total lending is close to that of the formal sector.

Some indication of the importance of informal finance can be found in recently completed research reports on the use of informal finance by several types of businesses and individuals. A 1987 study of small industry in Honduras by Goldmark et al. covering firms that were already receiving bank credit found that five of 47 firms surveyed had borrowed from moneylenders and four of 47 had used supplier credit. Informal loans ranged from L.100-15,000 with terms varying from one month to two years. Interest rates ranged from 1.5 to 2 percent per month with one case of 10 percent flat for 50 days (100.5 percent annual rate). Borrowers were satisfied with the services provided by moneylenders, particularly the speediness of access to needed cash.

A 1984 study of marketing channels and financing at the farm (350 small and medium size farms) and wholesale levels (50 intermediaries) for basic grains (corn, rice sorghum and beans) by Miguel Loria and Carlos E. Cuevas covering 5 of the 7 regions of Honduras indicated significant use of informal credit. Only six percent of the farmers received credit from formal financial institutions in the two crop seasons. On the other hand, ten percent of the farmers reported receiving cash advances (anticipos) from intermediaries for an average amount of L. 1,648.00 about 2.6 months before the harvest. About half of the marketing agents reported giving cash advances anywhere from 2 to 5 months in advance of the harvest. Consistent with other studies of this type, the grain study did not report explicit interest charges on these cash advances. Finance charges may be incorporated into the purchase price at time of harvest or may not be charged at all if the merchant who makes the advance perceives this as a way of securing future supplies of grain. A few marketing agents calculate the cash advance as a fixed percentage of the crop value

which varies according to how well the intermediary knows the client. For well known farmers, the cash advance equals what the farmer requests, but for new borrowers the cash advance is estimated from the farmer's cost per manzana. Often, the marketing agent offers other services such as technical assistance, inputs, bags, transportation, etc. to attract supplies of grain. These marketing agents/intermediaries have several sources of funds including own resources (48 percent), formal loans (40 percent) and informal sources (12 percent).

In 1989, the Financial Development Fund (FDF) completed a survey of the sources of credit for members of the cooperatives belonging to the federations FACACH, UNIOCOOP, CCC, and ANACH. Informal sources of credit far exceeded formal sources of credit among these members. The proportion receiving cooperative credit equalled 68, 83, 81, and 53 percent from FACACH, UNIOCOOP, CCC, and ANACH, respectively. No farmers reported use of moneylender funds, but the study mentions that farmers are often reluctant to speak of borrowing from moneylenders even if they use such credit. About 5 to 10 percent of members mentioned advance sale of products as a source of funds, and 10 to 20 percent mentioned savings as a source of funds. Loan size ranged from L. 1800 to 4200 with terms of 8 to 10 months and interest rates of 1 to 2 percent per month. Land and co-signers were the most frequent types of guarantees.

A 1989 survey of 1,000 small and micro-enterprises with manufacturing activities in shoe making, clothing, food and wood located in San Pedro Sula and Tegucigalpa found that only 25 percent of the firms had received credit. The firms obtained credit from NGOs most frequently (50%), followed by banks (20%), cooperatives (10%), and moneylenders (20%). Only 20 percent of the firms borrowing indicated that the amount borrowed had been adequate for their needs.

Rotating savings and credit associations (ROSCAs) consist of voluntary groups of individuals who save, share risk and borrow through contributions of a fixed amount of money to a common fund at fixed intervals. The contributors may draw lots or bid using a system of premiums and discounts to receive the distribution of the fund. While ROSCAs are common in many developing countries, they could not be found in Honduras, and no research studies have been identified that discuss them. If ROSCAs do exist, the use must be more limited than in many other countries. A popular alternative to the ROSCAs in Honduras is the "cooperativa" that functions as a voluntary savings club in which the members deposit money with the club on a regular basis and then borrow funds when needed. Like ROSCAs, these "cooperativas" consist of relatively small groups of people who are interested in saving and borrowing. Unlike ROSCAs, borrowing does not rotate among the members according to some pre-determined plan. These "cooperativas" tend to be very popular among office workers and other employees of private firms and public institutions that pay employees monthly or weekly.

C. IFMs and Financial Market Repression

Although Honduras has had informal financial market activity for many years, the increasing amount of such activity may be a function of financial market repression in the formal sector. The problems of increasing inflation in recent years (30 percent or more annually) together with various government market interventions have seriously disrupted formal financial markets. Some examples of policy interventions are interest rate ceilings on loans (and the consequent reduction in interest rates on deposits), an overvalued exchange rate, high bank reserve requirements, and loan targeting. One important effect of repression of the formal financial system is that financial activity is forced into the informal financial market which is not subject to these controls. Individuals lose confidence in the safety of and return on funds placed in the formal financial system and begin to seek other means of saving and borrowing. In this environment, IFMs offer an opportunity to earn higher returns on financial assets and more assured access to credit.

II. IFM PARTICIPANTS AND ARRANGEMENTS

A. Moneylenders

As mentioned above, Honduras has an unusual requirement of registration of moneylenders at the Superintendency of Banks. According to Decreto Ley No. 14 dated January 15, 1973, all non-bank moneylenders must register with the Secretaría de Hacienda y Crédito Público. The information requested includes the name of the borrower and the lender, the date of the loan, the amount, the interest rate, the length of loan and the guarantee required. The primary incentive for the moneylender to register is that judges and courts will not hear any case of loan default from a moneylender who is not properly registered. Moneylenders must also pay a fee to the GOH based upon the size of their portfolio, and they are subject to fines up to 25 percent of their loan portfolio for failure to register.

A total of 1,205 moneylenders have registered with the Superintendency of Banks and have a geographic distribution of 374 in Tegucigalpa, 560 in San Pedro Sula and 270 in the rest of the country. Most of those moneylenders who are registered are individually owned and operated, and less than ten percent of the total are firms. The total value of these loan portfolios may exceed L. 200 million, with loan sizes ranging from L. 1,000 to 200,000 and most loans are less than L. 10,000. Loan terms are typically six months to one year, with extensions possible. The legal interest rate ceilings are 18 to 24 percent per annum as

established by the decree. Some loans have a mortgage guarantee, many loans have only a fiduciary guarantee and some loans have no guarantee.

Small industry, micro-enterprises, and the commerce and service sectors tend to be the groups most frequently using moneylender services. In addition, some larger firms use moneylender services for bridge loans to cover short term cash flow problems or to obtain temporary financing while waiting for commercial bank loans. The loan terms, conditions and interest rates charged vary tremendously from borrower to borrower. For loans of 3 to 5 months with adequate guarantees, the effective interest rate is about 3.5 percent per month to good borrowers. Since only 2 percent per month can be charged explicitly, the rest of the interest rate charge is handled through fees or other means. Interest rates of about 10 percent per month are common with some moneylenders who discount payroll checks for employees who must borrow before they receive their payroll checks. When the check arrives it is endorsed to the moneylender who deducts 10 percent for his financing. According to field interviews, some employees discount their checks with a moneylender every month. On very small daily loans of L. 100 to 200, which is very common among the small merchants in the retail markets, the interest rate may be 10 to 20 percent daily. These small merchants may borrow L. 100 in the morning and pay back L. 110 or 120 in the afternoon. This continues daily for the very small merchant.

Loan default information is more difficult to obtain from moneylenders than from commercial banks (and such information can also be difficult to obtain from commercial banks). While it was not possible to quantify loan losses for moneylenders from the available data, conversations with lenders suggest that, although the default rate is not high, they do have problems of loan collection in some cases.

B. Trade Credit

Trade credit -- a very popular and most important form of informal credit in Honduras and almost every country -- assumes many different patterns because of the wide variety of goods and services financed. Retailers and wholesalers are major users of short term trade credit from manufacturers and suppliers to finance the inventories of goods sold in the marketplace. Retailers of shoes, clothing, household utensils and small appliances rely on the use of supplier credits. Interviews with retailers indicated that terms of 15 to 30 days are common, with no interest if goods are sold in that time, and the goods serve as collateral for the loan. Suppliers place a high value on the importance of this credit to retailers as a way securing a market for their goods. One bank in Tegucigalpa that attempted to compete in this market by financing retailers discovered that suppliers would cut off

supplier credit and goods to retailers who financed from the bank. Retailers of important consumer durables such as household appliances frequently provide consumer credit to buyers at 2 to 3 percent per month, with monthly payments lasting from 12 to 24 months.

Exporters and processing firms for commodities as diverse as bananas, beef, coffee, rice, and sugar provide financing to suppliers as a way of assuring themselves of supplies of the product for export or processing. Since these firms usually have lines of credit with commercial banks in addition to their own funds, they represent an important and efficient link between the formal financial sector and the informal financial sector. Beef processors in Honduras commonly advance funds to beef producers to finance the growing and fattening of cattle for their plants. In some cases, such trade credit may be the only source of funds for the producers, and in other cases the trade credit are short term funds to cover cash flow needs until bank loans are approved. Rice millers also advance funds to rice growers to assure adequate supplies for their rice mills. According to one interview, the rice millers charge interest for these funds at the rate of 3 to 5 percent per month. Input dealers supply trade credit to farmers for seeds, fertilizer, chemicals, machinery sales and many other items at 2 to 3 percent per month. Agricultural cooperatives provide credit to farmers for inputs as well as outputs. The coffee cooperatives associated with the Small Farmer Organization Strengthening Project of USAID lent over L. 1.5 million to about 375 borrowers in 1989-90. Other cooperatives in cotton, fruits, vegetables, rice and basic grains affiliated with the same project also lent small amounts of funds to farmers to finance about 14,359 manzanas of these crops in 1989. Many of the merchants interviewed indicated that access to formal bank credit is difficult for commerce and service activities because of the preference that banks give to financing agriculture and industry. Traders also mentioned lack of foreign exchange to import goods as a serious problem.

C. Credit Union Lending

The essential characteristics of credit unions -- cooperatives operated for the member-users on a profit basis (but with profits distributed to members) with management and control determined by the membership with one vote per member -- may create a natural advantage when providing financial services to small savers and borrowers. The Small Farmer Organization Strengthening Project of USAID/Honduras has as one of its objectives to strengthen rural credit unions in order to provide more and better financial services to borrowers and savers in rural areas. Growth in the key indicators of the 83 credit unions affiliated with FACACH from December 1985 to June 1990 is shown in Table 1. While the number of credit unions affiliated with FACACH has only increased by one

Table 1
 FACACH
 Federacion De Cooperativas de Ahorro Y Credito De Honduras
 Growth in Principal Items of Affiliated Cooperatives
 (Values in Thousands of Lempiras)

Item	December 1985	December 1986	December 1987	December 1988	December 1989	June 1990	Ratio of 1990 to 1985
Cooperativas (Credit Unions)	82	82	82	82	83	83	1.01
No. De Asociados (Members)	40,555	43,292	49,317	57,347	67,447	73,947	1.82
Aportaciones (Share Capital)	50,331	54,291	70,020	82,609	101,710	114,630	2.27
Depositos (Deposits)	7,902	10,328	11,863	16,395	17,875	21,783	2.75
Prestamos (Loans)	58,189	63,003	77,707	95,833	115,093	135,313	2.32
Reservas Estimadas (Reserves - Approx.)	571	846	N.O.	1,536	2,257	2,921	5.11
Activos (Assets)	71,491	76,951	N.O.	109,775	141,122	162,285	2.27

Source: FDF/FACACH

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in this nearly five year period, the number of members in these 83 credit unions has increased from 40,555 to 73,947, an increase of 82 percent. Share capital remains about 5 times the amount of deposits even though deposits increased slightly faster (2.75) than share capital increased (2.27) during this period. The loan portfolio of L. 135 million has increased at about the same rate as deposits and share capital. Reserves have increased about twice as fast as any other item, due in part to the USAID/Honduras strengthening project, and total assets have increased at about the same rate (2.27) as the other items. When these same items are adjusted for inflation in Table 2, the general pattern of growth in real terms for share capital, deposits, loans, reserves, and assets does not change from that in nominal terms. It is interesting to note that deposits doubled in real terms from December 1985 to June 1990 and that reserves more than doubled over the same period.

In the aggregate, loan portfolios are distributed as follows: (1) agriculture and livestock, 15%; (2) small industry and commerce, 40%; (3) housing construction and improvement, 30%; and (4) other uses, 15%. Most loans are for less than one year, with the exception of the housing loans that can be 4 to 5 years in length. About 11 percent of the portfolio is considered to be past due, with variations from less than 1 percent to 100 percent among the 83 credit unions.

Interest rates charged on loans and paid on deposits tend to be low relative to other segments of the informal sector and are currently far below the inflation rate. The maximum interest rate charged on loans by the credit unions has recently increased from 17 to 19 percent. They typically pay 9 percent on deposits (term deposits may go up to 14 percent) and up to 6 percent on share capital. The share capital requirements raise effective interest rates on loans above the stated rate, but these rates are still negative in real terms. When the inflation rate is running 30 to 40 percent annually, these interest rates are very attractive to borrowers and very unattractive to savers.

Comparing the top performing credit unions to all credit unions affiliated with FACACH demonstrates that the eleven best credit unions selected on the basis of FDF/FACACH information (Sagrada Familia, Chorotega, Elga, Usula, La Guadalupe, Fraternidad Pespirense, Ocotopeque, Standard, Ceibeña, Alianza Comunal Obrero, Nueva Vida) perform at much higher levels of achievement than all credit unions (Table 3). The change in selected performance indicators (i.e., growth in members, lending, share capital, savings, and total assets) from December, 1987 to June, 1990 is substantially higher for each indicator for the best credit unions compared to all credit unions. The accomplishments of the best performing credit unions indicate how well credit unions can perform when given the appropriate incentives to improve and when provided with good technical assistance and training such as that provided through the USAID/Honduras credit union project.

Table 2
 FACACH
 Federacion De Cooperativas de Ahorro Y Credito De Honduras
 Growth in Principal Items of Affiliated Cooperatives
 (Values in Thousands of Lempiras of 1978)*

Item	December 1985	December 1986	December 1987	December 1988	December 1989	June 1990	Ratio of 1990 to 1985
Cooperativas (Credit Unions)	82	82	82	82	83	83	1.01
No. De Asociados (Members)	40,555	43,292	49,317	57,347	67,447	73,947	1.82
Aportaciones (Share Capital)	27,221	28,130	35,399	39,966	44,806	45,852	1.68
Depositos (Deposits)	4,274	5,351	5,997	7,932	7,874	8,713	2.03
Prestamos (Loans)	31,470	32,644	39,286	46,363	50,702	54,125	1.72
Reservas Estimadas (Reserves - Approx.)	309	438	N.A.	743	994	1,168	3.77
Activos (Assets)	38,665	39,871	N.A.	53,108	62,168	64,914	1.68

* Deflated, using the consumer price index with 1978 equal to 100.

Source: FDF/FACACH

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Table 3
 Changes in Selected Performance Indicators
 for Eleven Best Credit Unions Compared to all 78 Credit Unions
 December 1987 to June 1990, Honduras

Performance Indicator	Change from December 1987 to June 1990	
	Eleven Best Credit Unions	All 78 Credit Unions
	- - - - - Percent - - - - -	
Number of Members	101	65
Loan Portfolio	101	68
Share Capital	90	69
Savings Deposits	122	80
Total Assets	98	75

Source: Calculated from FDF/FACACH data

D. Non-Government Organization Lending

Honduras has about 136 non-government organizations (NGOs) providing a wide variety of training, technical and/or financial assistance to many different kinds of public and private organizations, firms, and individuals. About 100 of the NGOs assist various organizations in education, environment, health, housing, water, sewers etc. but do not have active lending programs. About 35 of these NGOs provide one or more of the activities of technical assistance, training and credit to small and micro-enterprises located in urban and rural areas of Honduras. Micro-enterprises and small firms in the industry, commerce and service sectors represent an important group without access to formal financial institutions. Although no definitive study has been completed on the size of the small and micro-enterprise sector, estimates of the size of this group vary from about 80,000 to 130,000 firms without specifying precisely which economic sectors are included in these estimates. These firms represent the clients or the targeted beneficiaries of the NGOs in Honduras with technical assistance, training and/or credit programs. USAID and other donor agencies have programs with the NGOs to increase and improve the supply of credit, training, technical assistance and services to small and micro-enterprises. The largest of these projects is the USAID Small Business II project that started in August of 1988. This project works with the formal sector (11 cooperating banks) using a rediscount and guarantee mechanism to reach small and medium firms and with the informal sector NGOs (ASAPADE, FUNADEH) to reach small and micro-enterprises.

Faced with a large number of potential clients and a strong desire to help the small and micro-enterprises develop, most of the NGOs have worked very diligently to serve as large a number of client borrowers as possible. Notwithstanding these admirable efforts, the actual number of clients served by the most important of these organizations is quite small relative to the total population. As can be seen from Table 4, since the NGOs started functioning, they have reached a cumulative total of about 13,000 clients or 10 to 15 percent of the total population. The two largest NGOs (IDH and ASEPADE) have been functioning since 1972 and 1977, respectively, and the third largest AHDEJUMUR, has been operating since 1983. While these are the oldest NGOs, many of the other NGOs have been operating for at least five years. Thus, the number of client-borrowers served per year for all the NGOs is very small relative to the total population and probably less than 4,000 annually. The small size of these programs is problematic not only in terms of the target population but also in terms of the NGOs themselves and their long term financial viability in the credit and training business.

Table 4
 Number of Client-Borrowers
 Served by Non-Government Organizations (NGOs) in
 Honduras, 1990

Name of NGOs	Cumulative Number of Client- Borrowers Served	Time Period
ADIH*	86	Jan.-June 1990
AHDEJUMUR	1,498	1983-March 1990
ASCH	N.A.	N.A.
ASEPADE	3,766	1977-April 1990
CDLA	N.A.	N.A.
FACACH	62 Cooperatives	1983-June 1990
FEHCIL	37 Cooperatives	June 1990
FHA	390	1988-June 1990
FUNHDEMU	557	1984-May 1990
FUNADEH	1,341	1985-December 1990
IDH	6,000	1972-June 1990
ODEF	808	1984-April 1990

Source: Olivares

- * Asociacion para el Desarrollo Hondureno (ADIH); Asociacion Hondurena para el Desarrollo de la Juventud y la Mujer Rural (AHDEJUMUR); Asociacion "Save the Children" de Honduras (ASCH); Asesores para el Desarrollo (ASEPADE); Companeros de las Americas (CDLA); Federacion de Cooperativas de Ahorro y Credito de Honduras, Limitada (FACACH); Federacion Hondurena de Cooperativas Industriales, Limitada (FEHCIL); Fundacion Horizontes de Amistad (FHA); Fundacion Nacional para el Desarrollo de Honduras (FUNADEH); Fundacion Hondurena para el Desarrollo de la Mujer (FUNHDEMU); Instituto para el Desarrollo de Honduras (IDH); Organizacion para el Desarrollo Empresarial Femenino (ODEF)

Information on loan portfolios, average loan size, interest rate charged and time periods covered by the information is found in Table 5. The total amount lent to micro-enterprises is about L. 44 million during the entire period of operation of the NGOs. In any one year, the amount lent would be substantially less, probably in the range of L. 10 to 15 million per year. The data on average loan size show clearly that some of the organizations such as ASEPADE (average loan size L. 609) lend to the smallest borrowers of the micro-enterprise sector, while others such as FUNADEH (L. 7,681) lend primarily to small enterprises. The principal clients of the NGOs vary, so that the type of borrower in the portfolio also influences loan size. Most NGOs lend to the agricultural, industrial, commercial, and service sectors and some also lend to the housing sector. Industrial and agricultural loans tend to be larger, for example, than commercial loans. FUNADEH, for example, places about 69 percent of its funds with industry, 25 percent with service and 6 percent with commerce. Average length of loan is about 24 months. Most loans are in the L. 10,000 to 20,000 category, with women receiving 29 percent of the funds and men 71 percent. ASEPADE places about 51 percent of the funds with commerce, 35 percent with industry, and 14 percent with service. Women receive about 62 percent of the funds and men 38 percent, with most loans in the L. 400 to 800 range. Average length of loan is 3 to 4 months. FUNHDEMU lends to women for use in housing, commerce, service, and other needs with an average length of loan of about 6 months and an average size loan of L. 600.

Interest rates vary considerably among the NGOs, but most fall within the range of 12 to 19 percent annually. Only one NGO currently charges a rate as high as 24 to 36 percent per annum (Table 5). As in the case of credit unions, most annual nominal interest rates are well below the current inflation rate of 30 percent or more, resulting in negative real rates of interest. Hence, even if loan re-payments were 100 percent, the real value of the loan portfolios would decline through time. Compounding the effect of low interest rates, the realized return on the loan portfolios of most NGOs is substantially lower than the stated interest rate. Recently completed studies of the financial self-sufficiency of the NGOs conclude that the interest rate policy on loan portfolios requires major changes to increase the actual yield on the portfolios (ASEPADE by Gordillo, FUNADEH by Heinzen, and FUNHDEMU by Arguello). For ASEPADE, the nominal rate is 26 percent on the loan portfolio, but the actual yield is 22 percent; for FUNADEH the stated rate is 17 percent on the loan portfolio, but the actual yield is only 14.4 percent, and for FUNHDEMU the nominal rate is 36.8 percent, but the actual yield is only 15.6 percent on the loan portfolio. The problem may be similar for other NGOs for which studies to examine financial self-sufficiency are underway, but the results were not available at the time of this field work. The main ways for the NGOs to improve the interest rate yield on the current loan portfolio are to change policies to include more

Table 5
Total Amount Loaned and Average Loan Size to
Microenterprises by Non-Government Organizations (NGOs) in
Honduras, 1990

Name of	Total Amount Loaned in Lempiros	Average Loan Size	Annual Interest Rate	Time Period
ADIH*	180,000	837	N.A.	Jan.-June 1990
AHDEJUMUR	1,284,000	5,585	12%	1983-March 1990
ASCH	120,880	N.A.	17%	1988-June 1990
ASEPADE	12,889,543	609	24-36%	1977-April 1990
CDLA	13,000	N.A.	17%	N.A.
FACHACH	7,300,000	173,121	12-17%	1989-June 1990
FEHCIL	2,999,697	30,000	N.A.	1983-June 1990
FHA	N.A.	N.A.	12-18%	N.A.
FUNHDEMU	962,106	606	14%	1984-May 1990
FUNADEH	10,279,650	7,681	17-22%	1985-December 1989
IDH	7,373,000	1,229	20%	1972-June 1990
ODEF	496,527	1,054	19%	1984-April 1990
Total 43,898,926				

Source: Olivares

Asociacion para el Desarrollo Hondureno (ADIH); Asociacion Hondurena para el Desarrollo de la Juventud y la Mujer Rural (AHDEJUMUR); Asociacion "Save the Children" de Honduras (ASCH); Asesores para el Desarrollo (ASEPADE); Companeros de las Americas (CDLA); Federacion de Cooperativas de Ahorro y Credito de Honduras, Limitada (FACHACH); Federacion Hondurena de Cooperativas Industriales, Limitada (FEHCIL); Fundacion Horizontes de Amistad (FHA); Fundacion Nacional para el Desarrollo de Honduras (FUNADEH); Fundacion Hondurena para el Desarrollo de la Mujer (FUNHDEMU); Instituto para el Desarrollo de Honduras (IDH); Organizacion para el Desarrollo Empresarial Femenino (ODEF)

emphasis on loan collection, to reduce late payments, encourage prompt payment of monthly installments of interest and principal, and to implement a policy of additional charges for late payments.

One factor contributing to the low interest yield on the loan portfolios is the high loan delinquency rates for the NGOs. Past due loans for ASEPADE as of July 1989 equalled 25 percent of the L. 1.5 million portfolio, with more than half of the past due amount being over 90 days late. As of April 1989, the FUNADEH loan portfolio consisted of a balance of L. 2.9 million, with L. 318,225 that is past due, or 10.7 percent of the outstanding balance. The same document also contains analysis of the first 800 loans made in the period June 1985 to September 1988 -- 441 active loans in the amount of L. 1.4 million with 131 past due (30%) in the amount of 195,136 (14%). A large proportion of these loans are more than 90 days past due which raises some question about the amount of these loans that can be recovered. FUNDEHMU had an outstanding loan portfolio of L. 129,800 on March 31, 1990, with a past due amount equal to 11.4 percent of the portfolio, but with very little past due over 90 days. The self-sufficiency studies currently underway for the other NGOs will very likely discover similar conditions in the loan portfolios of these institutions.

Financial self-sufficiency will be a very difficult goal for the NGOs to reach. Results of the studies mentioned above found that no NGO is financially self-sufficient at the present time and that the best NGOs (FUNADEH was about 70 percent self-sufficient in 1987 and is currently estimated to be about 80 to 90 percent without including training costs) need more than two years, large scale lending programs and many internal adjustments to achieve self-sufficiency. Moreover, NGOs do not capture savings deposits and thus have no positive impact on the development of savings mobilization capacity in the country. Since NGOs do not capture deposits, they depend on outside funds to a very high degree, and some internal funds from the credit and training programs, to cover the costs of operation. Most NGOs started with grants and/or concessional loans from some external donor such as ACDI, CARE, Christian Childrens Fund, Cooperative Housing Foundation, Inter-American Foundation, USAID, IDB, World Food Program, etc. and continue to depend upon these external funds. The NGOs in the micro-enterprise sector have received a total of L. 19.3 million from donors, such as those above, in 30 agreements that include 11 loans and 19 donations. Long term viability as a financial institution ultimately requires independence from these external funds and financial self sufficiency for the NGOs.

III. ELEMENTS OF IFM SUCCESS

A. Why Borrowers Choose IFMs

Interviews with borrowers and lenders revealed a number of reasons why borrowers choose IFMs rather than formal financial institutions. Although interest rates charged to borrowers in IFMs that can be more than double the interest rates charged by formal financial institutions, borrowers are attracted to IFM lenders because of their many advantages (Table 6). Primary among these advantages is access to credit. A very high percentage of the borrowers in the informal sector do not have access to funds from the formal sector. Even when there is some potential for access to formal lenders, it is neither convenient nor certain. Informal arrangements, on the other hand, often enjoy the advantage of greater proximity to the borrower, especially in rural areas, which reduces the borrower's time costs and travel costs to obtain a loan. Access to credit in IFMs is also easier because of longer business hours (including weekends and evenings), and a more familiar, more personal and less intimidating environment for the borrower compared to a formal financial institution. Borrower transaction costs are reduced because the amount of paperwork required for a loan is minimal and may be only a handshake in some cases.

Borrowers also like IFMs because the use of the funds -- for consumption or production or whatever purpose -- is not as restricted as that of development bank and some commercial bank lending which attempts to limit financing to a designated set of approved activities. Borrowers consider quickness (timeliness) in obtaining a loan from an IFM lender a major advantage. Many lenders in IFMs provide same day service in making loans (but one week is a more typical amount of time), compared to the many days, weeks and even months of waiting to obtain a loan from most formal financial institutions.

Flexibility of terms and conditions is another important advantage of IFMs. This includes flexibility of interest rates depending on the risk and credit worthiness of the borrower and the size of the loan. (Small loans carry higher interest rates than large loans.) IFM lenders have more flexibility in loan size and interest rates in order to serve a broader range of borrower needs than formal financial institutions. In the past, commercial banks have not had as much flexibility because of interest rate controls. Because of interest rate differentials and lower lender transaction costs, IFMs can profitably make a large number of small loans and thus serve the important small borrower segment of the market that formal financial institutions cannot profitably serve. IFM lenders also offer considerable flexibility in loan duration and the scheduling of repayments. In the Honduran IFMs, some loans are daily or weekly, with most loans ranging from 30 to 90 days, but longer terms up to a year can also be negotiated. Many times the

Table 6
 Advantages of Informal Financial Market Services for Borrowers
 Compared to Preferential Credit Lines From Formal Financial Markets
 Honduras, 1990

Item	Informal Financial Markets	Preferential Credit Lines
Interest Rate	Positive real rates	Low or negative real rates
Loan Size	Small to Medium	Large
Length of Loan	Short term	Long term
Lender's transaction costs	Low	High
Access	Easy	Difficult
Hours of service	Convenient	Restricted
Guarantees	Varied	Standardized
Repayment schedule	Flexible	Rigid
Atmosphere	Personal	Intimidating
Loan Approval & Disbursement Time	Days	Weeks or Months
Number of Loan Disbursements	One	Several
Borrower's Transaction Cost:		
Travel Time	Little	Considerable
Travel Costs	Low	High
Paperwork	Minimal	Plenty
Other Costs	Few	Several
Restrictions on Use of funds	None	Targeted

loan continues automatically for as long as the client desires so long as the borrower pays the interest charge on schedule. Commercial banks simply cannot lend small amounts profitably on such a short term basis because of their high lender transaction costs and documentation requirements. IFM lenders have more flexibility to reschedule repayments in the event of loan repayment difficulties than do commercial banks that often only refinance the loan at considerable cost to the borrower.

One of the more important advantages of IFM lenders is the ability to offer more flexibility in loan guarantees than commercial banks. Depending on the borrower and lender, IFMs will accept a wide variety of items as collateral for a loan. In pawnshops, for example, jewelry, telephone lines, cars, machinery, tools, televisions, stereos and other household goods are commonly accepted as collateral for loans. Typically, the loan amount equals about half the value of the collateral, although this can go as low as 25 percent of the value of the item depending on the type of collateral offered as a guarantee. The borrower must have proof of ownership, such as the sales order for the item. Tegucigalpa has about 12 pawnshops which appear to conduct a considerable business. One of the pawnshops is government owned and operated. Pawnshops use owner financing as the principal source of funds, but they also accept outside funds. Some of the pawnshops pay 3 percent per month on funds from investors and charge 10 percent per month to borrowers. Many loans of L. 50 to 100 are made, and some loans of L. 1,000 or more are also made. A typical loan is for 60 days, which can continue for longer periods as long as the borrower pays the interest. In the case of default, the item is sold for the pawned value plus accrued interest, or more, if possible.

B. Why Savers Choose IFMs

Savers with funds for "deposit" appear to choose IFMs primarily because of the higher interest rates that can be earned on those funds. Honduras has individual and corporate moneylenders who accept funds and lend funds to the public. Some corporate moneylenders which attract significant resources from private savers include: (i) finance companies which are often owned by commercial banks, (ii) credit card companies, also often owned by commercial banks, and, (iii) leasing companies.

Moneylenders indicated that interest rates paid to savers are 1.5 to 2 percent per month, or about double the interest rate that could be earned on deposits in formal financial institutions. Individual and corporate moneylenders as well as some pawn shops receive funds in this manner. Since funds cannot legally be "deposited" with these moneylenders, the saver lends to the moneylender in return for a promissory note at some interest rate or invests funds in the business for profit. The risk of loss for these funds is clearly higher than for bank deposits, although

during the field work it was not possible to quantify the level of this risk. The level of risk in Honduras appears much lower than in Bolivia, for example, where the author observed numerous cases of individuals who had "deposited" funds with moneylenders but lost the funds when the moneylender left town.

Savers may also choose IFMs because the confidentiality of deposits facilitates the evasion of income tax payments on interest earnings. The government can identify interest earnings on deposits in the formal sector with little difficulty, while interest earnings on deposits through IFMs cannot be easily identified.

IV. Performance of IFMs: Lessons for the Formal Sector

Honduran IFMs are not small in number and type of agents nor in amount of loan activity. For example, the individual and corporate moneylenders registered with the Superintendency of Banks exceed 1,200 and have a loan portfolio estimated at about L. 200 million. According to many sources, the loan portfolio is nearly the size of the formal sector and increasing, while the formal sector is contracting. The large number of agents in IFMs in combination with the relatively small size of any one individual suggests that the IFMs are contestable markets and not the monopolistic, exploitative markets frequently mentioned by policy makers. New competitors can enter the market with little capital, know-how or regulatory barriers to entry. As mentioned above, many types of agents such as individual and corporate moneylenders, finance companies, leasing companies, credit card firms, non-government organizations, credit unions, traders and merchants of all kinds, pawnshops, and agricultural cooperatives operate in this IFM to create a very competitive market.

Because of the particular needs of informal and small-scale borrowers, IFMs serve and will continue to serve some segments of the financial market system better than the formal system even if the formal financial system was operating efficiently in a free market environment without the current policy constraints. Interviews with borrowers and lenders revealed a number of reasons why they choose IFMs over formal financial institutions. For borrowers, these reasons include:

- * access to loans for informal sector agents who do not meet all the banking requirements (character, collateral, and cash flow) of the formal sector.
- * lower borrower transaction costs such as lower time and travel costs.
- * timeliness of informal lending whereby the fast, simple loan application and disbursement process lets the

borrower know quickly if the loan is approved and, if approved, the borrower receives the money rapidly.

- * flexibility in the wide variety of guarantees that can be accepted for a loan.
- * flexibility in the loan size, duration and interest rate charged according to borrower needs.
- * longer hours and friendlier, more convenient service.

Savers with funds for "deposit" appear to choose IFMs primarily because of the higher interest rates that can be earned on these funds. Savers may also choose IFMs because the confidentiality of deposits facilitates the evasion of income tax payments on interest earnings. Individual and corporate moneylenders accept funds and lend funds to the public. Some of the corporate moneylenders that attract significant amounts of funds from private savers include: finance companies, which in many cases are owned by commercial banks; credit card companies, owned by commercial banks; and leasing companies. The interest rates paid to savers, 1.5 to 2 percent monthly which is twice times the formal financial market rates, have to reflect all the costs including the risk premium of placing funds with IFMs. The risk of loss on these funds is clearly higher than for bank deposits, although during the field work it was not possible to identify the level of this risk.

In terms of the agents who provide informal financial services, an important advantage of IFMs over formal financial markets is the lower lender transaction costs (higher operational efficiency) for small-scale transactions. This efficiency derives in part from lower information and supervision costs due to the agents' close ties and better knowledge of borrowers. The low lender and borrower transaction costs of IFMs differ sharply from the transaction costs of formal financial markets where the lender costs are higher and the borrower transaction costs or non-interest costs of borrowing for a small loan frequently exceed the interest costs.

These performance characteristics indicate that the IFMs well serve and will continue to serve many clients in the financial sector. Nonetheless, there are important lessons to be learned by the formal financial system from the financial services provided by IFMs. The formal banking system could serve more of these clients with more aggressive deposit mobilization, a simpler loan application, disbursement and collection process, and more attention to retail banking under a different ownership structure. The current ownership structure of commercial banks in Honduras fails to create the appropriate incentives for banks to pursue retail banking aggressively. This occurs in large part because the

primary purpose of the commercial banks appears to be serving the borrowing needs of the other businesses of the bank's owners at low rates of interest. Such "related lending" is a typical result of financial repression.

Overall performance of the financial market system could be improved with policies that reward the holding of financial assets and return price stabilization to the country. Elimination of interest rate ceilings and high reserve requirements would create stronger incentives to save and borrow through the formal financial system. Elimination of the overvalued exchange rate would reduce the incentives for capital flight and allow both the formal and informal sector to operate more efficiently in the country. Such policy reforms might encourage the formal system to serve more IFM borrowers and savers and so improve the allocation of resources between savers and borrowers in the total economy. Even though IFMs perform this function on a limited basis, integration of these clients into the banking system would improve allocative efficiency in the economy. Governments need to find ways to improve the performance of IFMs through policy incentives to improve all financial markets rather than regulations such as Decreto 14 (regulating money lenders) that may be politically popular, but have negative consequences for the entire financial system including the borrowers and savers who are the intended beneficiaries of such policies.

USAID and other donor agencies currently have projects with some agents of IFMs aimed at reaching more small savers and borrowers at lower cost and expanding the scope of financial market services in urban and rural areas of Honduras. The USAID Small Farmer Strengthening Project with the credit unions and agricultural cooperatives represents an important intervention strategy designed to strengthen these institutions through technical and financial assistance which will help them to reach borrowers and savers who currently do not enjoy access to formal financial services. In total the credit unions are clearly stronger than before. Membership in the 83 credit unions affiliated with FACACH had increased from 40,556 in December of 1985 to almost 74,000 by June of 1990 and the loan portfolio equalled L. 135 million. The real value of share capital, deposits, loans, reserves and assets had increased by 68 percent, 100 percent, 72 percent, 277 percent and 68 percent, respectively during this same time period. When using these same indicators, the 11 best credit unions performed much better than all 83 credit unions. Many of the other credit unions have financial and management problems which they are attempting to solve with assistance from the project. Performance of all credit unions can be improved since all credit unions need to adopt a policy of paying positive real interest rates on deposits, charging positive real rates on loans, and improving their business management systems.

USAID and other donor assistance to the NGOs is another intervention strategy that reaches small and micro-enterprise borrowers who do not have access to the formal financial sector. The Small Business II project of USAID proposes to strengthen and expand the institutional system to increase and improve the supply of credit, training, technical assistance and services to small and micro-enterprises. While the effort of these programs is admirable, currently they reach a very small percentage each year (probably less than 5 percent) of all the small and micro-enterprise firms in the country. The 35 NGOs with lending programs have lent about L. 44 million to about 13,000 clients over the life of these projects (which in some cases exceeds 15 years). Furthermore, the NGOs do not seem to be making rapid progress toward masification of lending programs, charging higher interest rates and resolving the past due loan problems needed to achieve financial self-sufficiency.

The NGOs could become an important link from IFMs to the formal sector -- reaching large numbers of small borrowers -- if the NGOs could achieve financial self-sufficiency. This would permit them to borrow from commercial banks (as any other commercial borrower), lend to the micro enterprise sector, collect payment from micro enterprise borrowers and repay commercial banks.

Large increases in trade credits could become another important link from IFMs to the formal sector that could reach large numbers of small borrowers. Marketing agents and moneylenders currently serve far more small and micro-enterprise borrowers and savers than any of the other IFM agents studied in this report. Still, these intermediaries have difficulty obtaining adequate financing from commercial banks because of the bias against trade credit relative to industrial or agricultural credit. Removing these obstacles to trade credit would increase significantly the flow of funds from banks to traders and, ultimately, to small borrowers.

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Numerous merchants, pawnshops and moneylenders in and around the market place.

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