PN-ABU-990

ISN 94819

BOOK REVIEW

LOCAL SUPPLIERS OF CREDIT IN THE THIRD WORLD, 1750 - 1960

April, 1995

Karla Hoff

Working Paper No. 157

Working Paper Series

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PN-ABU-990

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This publication was made possible through support provided by the U.S. Agency for International Development, under Cooperative Agreement No. DHR-0015-A-00-0031-00.

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<u>LOCAL SUPPLIERS OF CREDIT IN THE THIRD WORLD,
1750 - 1960</u>

Gareth Austin and Kaoru Suguihara, eds.

The McMillan Press, London
St. Martin's Press, New York
1993

Journal of Development Economics March 27, 1995

Gareth Austin and Kaoru Sugihara, eds., Local Suppliers of Credit in the Third World, 1750-1960 (The MacMillan Press, London and St. Martin's Press, New York, 1993), pp. 318. $65.00.

ISBN 0-333-52320-2 (The MacMillan Press)
ISBN 0-312-08559-1 (St. Martin's Press)

The consensus within development economics on the importance of studying informal financial institutions is shifting. One view has been that such institutions are efficient and that therefore if we want to study how societies (without government intervention) allocate resources, we need only study efficient resource allocations. An alternative view that has recently attracted significant scholarly attention is that institutions, including informal financial institutions, that provide incentives to savers, promote the specialization and division of labor, and channel resources to innovators should be the central focus of study in efforts to explain development. As Douglass North and Robert Thomas argued in The Rise of the Western World (1973), "innovation, economies of scale, education, capital accumulation ... are not causes of growth; they are growth." In this view, the research agenda in development economics should be to uncover the sources of the development of institutions that make growth possible.

This timely book edited by Gareth Austin and Kaoru Sugihara contains nine papers on the role of moneylenders and local and regional bankers in the modern economic history of Asia, Africa, and Latin America. It is intended as a critique of ahistorical assumptions about the 'unorganized' or 'informal' sector of credit suppliers, which depict it as static and incapable of fostering large-scale development. Approximately the first third of the book discusses local indigenous lenders in India, Japan, and West Africa before those areas were subject to large-scale colonization. The next third covers European settlers who set up financial institutions in West Africa, Natal, and Argentina. The last third of the book describes regional suppliers of credit--suppliers of credit within the Third World across political frontiers--of whom the most notable are the Chettiar caste of Indian moneylenders in Southeast Asia.

The essays in this book draw on a wide variety of primary sources--bankruptcy notices, business accounts of 18th and 19th century moneylenders and bankers, diaries, memoirs of princes. The richest of these primary sources is perhaps that used in the paper by Ronald Toby, based on the ledgers of one Japanese family that form a nearly complete annual series from 1764-1925. Toby is able to document from this source alone the transformation of the credit operations between 1829 and 1844 of a village headman and his successor (his son) from that of a simple moneylending operation--lending from the family's own capital--to something that may well be described as a fractional banking system, shored up by a network of wholesale credit provided by other local financiers who were entrepreneurs and headmen in nearby villages. Within a 15-year period, rural credit in the Mino lowlands was completely reorganized, and the network of local bankers came to operate with a deposit multiplier of three-to-one or four-to-one. Thus there appears to have emerged in Japan an institution capable of having a multiplier effect on the local money supply. The ledgers of this family also indicate an increase in the average real loan size over this period, which suggests that the borrowers were not the very poor, but rather small-scale commercial capitalists. This evidence supports the view that the rural reorganization of credit provided an important ingredient for fuelling growth and structural change in Tokugawa Japan.

The (old-fashioned) textbook sequence of development is that first power is centralized, and then the political system creates a set of rules and sanctions that promote efficient exchange. It is not clear to what extent this sequence characterizes developments in Tokugawa Japan, but precisely the opposite sequence is described in the essays on 18th century India by Peter Robb and G. D. Sharma. During the disintegration of the Mughal empire in western India, but prior to the emergence of regional states, lenders relied on informal institutions (which unfortunately are not described in detail) for obtaining deposits and enforcing repayment of loans. Aspirants to central political power then *used* the informal lenders as their treasurers who would finance day-to-day government operations as well as warfare. Thus, in 18th century Gujarat, "the rulers were ... totally dependent on commercial capital, so that the bankers became partners of the state." (p. 40) High political office was conferred on the highest bidder, who was then required to collect revenue and maintain law and order. This system was part of a widespread system of tax farming (which was also the means by which Louis XIV collected revenues from peasants). Interestingly, in western India the bidders for the right to collect tax revenues generally *colluded*, so that, gaining much of the revenues for themselves, the supply of commercial capital was greatly increased, and, in turn, employed in commercial activities. In this way tax farming integrated the urban and agrarian economy.

In the Indian state of Baroda, the state did not maintain its own treasury; the treasurer was a banker (a *potedar*). The *potedari* system dominated the financial arrangements to such an extent that even the British East India Company found that the way to penetrate the affairs of Gujarat was to assume the role of a creditor. This dependence on bankers lasted till after the British East India Company acquired political control in 1770s. Only in 1811-12 did the British transform the tax farmers into civil servants.

Three essays in this volume focus on the relation between financial development and economic growth during periods of rapid export growth. The essay by W.G. Huff describes the establishment in the years 1920-1940 of the rubber and pineapple industries by the Singapore Chinese in British Malaya. This development occurred despite the lack of credit, and despite the fact that capital requirements of rubber plantations were significant. On the Chinese-owned, but not the European-owned, plantations, the practice developed of planting pineapple trees between the rubber trees because they yielded fruits within 18 months. The sale of pineapples created a cash flow to help finance care of the rubber trees, which required eight years to mature. The pineapple plants did not receive fertilizer or other capital expenditures and were abandoned when the rubber trees were mature. By using pineapples, it cost roughly $150 per acre to develop a Chinese-owned rubber estate compared to $600 per acre to develop a European-owned rubber estate. And to finance the $150, a form of sharecropping evolved that allowed part of the financial risk of estate development to be shifted onto and spread among the estate labor force. Under this system, the sharecroppers received a large portion of their pay in the form of a share of the pineapple proceeds. The entrepreneurs were in effect able to borrow from their work force by producing pineapples jointly with rubber trees. The general point is that informal institutions thereby got around the absence of credit (at a cost in efficiency which is not discussed).

But the story does not end there. Once the rubber plants matured, the Chinese owners typically sold the estates to Europeans. With that capital, they developed a Chinese deposit banking system from 1912 onwards. These banks then gave Chinese entrepreneurs in Malaya access to finance, permitting them to expand their role in other sectors of the Malayan economy. By 1938, the Singapore Chinese had the largest network of Chinese banks outside China.

The essay by Jeremy Adelman focuses on Argentina in the period 1879-1914. In those years, Argentina developed from a non-exporter of wheat to one of the top five wheat exporters in the world. Adelman's surprising finding is that banks lent very little to farmers. Banks favored ranchers, who owned estates, and manufacturers, where returns were high. In contrast, wheat farmers, who were generally tenants and generally immigrants, did not appear attractive risks. Like many small farmers in developing countries today, the wheat farmers depended for credit primarily on local merchants, who borrowed from formal lenders and onlent to farmers to finance their variable capital needs. The dual credit markets did not prevent agriculture from expanding, but by cutting wheat tenants off from all but short-term loans, it reinforced a structure of property relations where a few operators had a great deal of land, while the majority were landless. The expansion of wheat exports was driven not by financial development, but by the availability of cheap land opened up by a new railway system and by the inflow of immigrants.

The essay by Rajeswary Brown focuses on the role of Chettiar capital in the economic transformation of Southeast Asia c.1850- c.1930. The Chettiars are a caste of Indian moneylenders who accumulated capital from within their own community and within Southeast Asia, and ultimately gained access to short-term credit from Western banks as well. In the period 1850-1930, the Chettiar network of long-term finance made possible a vast expansion in the production of rubber, rice, timber, and coconut in Southeast Asia. They were remarkably efficient: Brown argues that by 1900, interest rates charged to peasants in Southeast Asia were linked to interest rates established on Western capital markets. Unlike other lenders, the Chettiars had developed a system that permitted them to lend long on light security. As late as 1941, Chettiar investments in Burma still accounted for $350 million, or 36 percent of total foreign investment in the country. This essay contains the following description of the Chettiars' operations:

> The business structure was based on flexible partnership in which members of the same family could be partners in several different firms; this created an interlocking community of moneylenders. Each partnership operated through a system of overseas agencies, the agents being the younger partners sent out to manage an agency on three-year terms. Each agent received an advance, a monthly salary, and a share in the agency's profits. Central control was exercised through a requirement that the agent submit full accounts each week or month to the partners in India. The community's cohesiveness, reinforced by temple and caste discipline, ensured an essentially coordinated functioning of the overseas agencies. (p. 258)

In summary, these three essays, covering periods of rapid export growth in British Malaya, Argentina, and Southeast Asia, offer windows on three different sequences of financial and economic development. In British Malaya, economic growth preceded and made possible indigenous financial development. In Southeast Asia, development of a far-flung regional supplier of credit preceded and made possible economic growth. In Argentina, economic growth coexisted with a highly dualistic financial market. Decades of research have failed to produce a consensus on the causal relationship between financial development and economic development. One reason why this is so is that too much institutional detail is lost in the process of fitting general purpose equations that constrain equality in coefficient estimates across sectors. These three essays, which document the relationship within specific sectors between finance and economic growth, indicate the shortcomings of a simple uni-directional view, whereby financial development causes economic development or *vice versa*. They do not, of course, tell us whether examples of economic growth preceding the development of formal finance were exceptions in a larger pattern in which financial underdevelopment does undermine growth.

The book has two main weaknesses. It will not be an easy book for students to use--there is no index and only a short introduction by the editors. The papers do not refer to one another and, with the exception of the papers by Toby and Huff, they do not refer to the general economic literature.

More important, there is little analysis in these essays of the development of customary law and of the information networks that must have underpinned lending activity. Did private codes of commercial law evolve in Tokugawa Japan or among the Chettiars in Southeast Asia (as we know they did in medieval Europe)? How did rules of punishment evolve? The book provides remarkable evidence that, as early as the 18th century in parts of Asia and Africa, institutions existed that made it possible to lend over hundreds or thousands of miles. But the book is only an invitation to future efforts by historians and economic theorists to dissect the structures that made such exchange possible. ■

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