FINANCIAL DUALISM AND FINANCIAL SECTOR DEVELOPMENT IN LOW INCOME COUNTRIES

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1. Introduction

Finance, contrary to popular perception, means not only the provision of credit, but also the accumulation of savings. The two, however, are useless unless interconnected via a system. That system, called the financial system, converts savings into credit by bringing together those economic units that want to postpone the consumption of their current incomes to the future and those that want to spend their future earnings now. When the various forms of savings and credit flows between these economic units are recognised, controlled and legally backed by the laws of a given country or region, the process is formal and the system supporting them is called the formal financial system. Central to it is the fact that aggrieved parties can seek legal redress when unsatisfied with their transactions. On the contrary, savings and credit flows via unrecognised and uncontrolled systems without legal backing are referred to as informal, and the system via which they flow called the informal financial system. When the two coexist in a given country or region, the financial system is said to be dualistic.

However, financial dualism is subjective. Some authors, e.g., Ghate et al. (1992, pp.9-10), Thillairajah (1994, p.20), Adams and Fitchett (1992, p.2), etc., refrain from using it because formality and informality are relative concepts and placing clear cut boundaries between them is hard. In between are savings and credit flows via financial systems that are neither formal nor informal. This middle ground, called the semi-formal financial sector (SFFS), is not controlled by specific regulations that direct the activities of the formal financial sector. But its activities are legally enforceable implying that aggrieved parties find legal redress to their problems. This paper treats the SFFS as formal due to the legal attention it receives. It, therefore, addresses financial dualism in the context of formal and informal financial sectors thereby enforcing the sharp distinction between them. It intends to show that the financial sector of low income countries (LICs) is dualistic, its size is large and has sparred a number of developments into the sector. However, because the IFS's role in serving the majority who are faithful to it have always been ignored, neglected or assumed, they have often failed to achieve their goals.
2. Financial Dualism

There are basically two strands of arguments that explain financial dualism. The first presents the existence of the informal financial sector (IFS) as a response to the formal financial sector’s (FFS) shortcomings and excessive regulation. The second argues that the IFS results from the dualism of the economies of LICs. Other factors also exist, however, that explain it too.

2.1 A response to the deficiencies of the FFS and excessive regulation

This strand of literature postulate that financial dualism results from the deficiencies and inefficiencies of the FFS and its close regulation which have made it too urban, too bureaucratic, too regulated and too rigid (Germidis, Kessler and Meghir 1991, p.50) to supply financial services that the majority in LICs demand. Its proponents, the defenders of financial market liberalisation (McKinnon 1973; Shaw 1973; Fry 1988; Adams, Graham and Von Pischke 1984) and more recently the Ohio State University group amongst others, contend that on a macro-scale, the monetary and financial policies pursued by many LICs are not suitable and might have fuelled financial dualism. These policies which include interest rate controls, confiscatory reserve requirements, overvaluation of the domestic currency, credit subsidies, e.g., via credit issued at below market interest rates and mandatory selective credit allocation, excessive restriction on market entry, etc., led to "financial repression." This ensured close regulation of the financial system and imposed restrictions upon the activities of the financial institutions that taxed or subsidised their transactions, distorted the functioning of the market, misallocated financial resources, slowed down investments because of reduced or excessively unstable returns and consequently discouraged the development of financial institutions and instruments (Gonzalez-Vega and Chaves 1994, p.56). The product being dualistic financial markets. A closer look at some of the restrictive policies clarify this strand of argument.

2.1.1 Interest rate controls

Imposing interest rate controls is usually designed to improve access to credit and encourage investments by keeping interest rates low. This can be done directly by charging below market rates of interest on loans or indirectly by paying low rates of
interest on deposits since it is assumed that financial institutions which obtain credit cheaply will be able to advance loans cheaply too. But lower deposit rates of interest that do not reflect market rates and which during times of high inflation become negative, discourage savings. In fact, as negative deposit real interest rates rise due to high and rising inflation, households become unwilling to hold money savings in financial institutions. They demand rather, inflation hedges, e.g., cattle, real estate, commodities, etc., which in general, yield quite low rates of return and pay, according to Vogel (1984b, p.250), "an inflation tax on any cash or deposits held for current obligations." Other informal savings arrangements come into play too, resulting in fragmented financial markets.

On the other hand, lending rates controlled below the market lead to credit rationing by the financial institutions. Credit becomes cheap and creates excess demand in the market. However, the institutions can neither raise interest due to the excess demand nor charge a risk premium equivalent to the risks of projects they finance because of the officially administered rates. Lending institutions, therefore, resort to credit rationing by squeezing out the most costly, the most risky and the least influential borrowers (Vogel 1984a, pp.137-138 & p.141). Such borrowers, denied access to cheap loans, turn to the IFS.

This policy of credit rationing was employed in LICs with sober intentions to avail cheap credit to small scale farmers and non-farm entrepreneurs without access to FFS credit. However, it mainly improved the accessibility of large scale farmers and entrepreneurs to the loan portfolios of the FFS. This encouraged them to take up more investments and therefore more risks than some would be able to accommodate, leading to the problem of moral hazard. But it limited small-scale farmers and entrepreneurs accessibility to the same, thereby adversely selecting investment projects, denying funding to some that would yield highest returns. This policy of the iron law of interest rate restrictions (Gonzalez-Vega 1984, pp.85-87), concentrates the distribution of credit amongst the rich by excluding small scale borrowers from FFS loans effectively pushing them to the IFS.

2.1.2 Selective credit allocation

Selective credit allocation has also been used in LICs to address the deficiencies of the FFS. The financial technology of FFS institutions, especially banks, was blamed for unequal development and distribution of wealth. This policy intervention, therefore,
was intended to rectify the situation by providing credit to market segments that the FFS institutions could not adequately serve. It was employed in two ways. The first entailed administratively setting up sectoral lending targets for financial institutions and compelled them to direct a given percentage of their loans to specific government priority sectors, enterprises or borrowers (Von Pischke 1991, pp.99-105). For this the government would compensate them either through lower minimum reserve requirements, lower rates of taxation, rediscount lines or interest rate subsidies, etc., (Germidis, Kessler and Meghir 1991, p.52). Nevertheless, this restricted funding to the non-targeted, non-priority sectors, enterprises or borrowers and subsequently raised the cost of funds available to them. Many of them, especially the poor and small and micro enterprises (SMEs) who demand unsecured, small, non-cost effective loans, were pushed out of this credit market. The IFS was consequently favoured to grow to fill the niche. In addition, credit ceilings set for these institutions directed towards fulfilling the credit needs of the government priority sectors may hamper their competition for savings. Once they attain the set limits, extra savings become idle cash balances which may not be transformed into credit. The institutions rational response is to stop their efforts of attracting savings rendering potential savers unwanted customers who then resort to the IFS for savings. These were done through the high minimum deposits.

The second alternative involved establishing specialised credit institutions whose purpose was to channel low-priced loans to priority sectors. Their goal, like the first alternative’s, was to improve accessibility of the priority sectors to credit, whose shortage or lack was assumed to be the bottleneck to their increased production. The 1970s and 1980s, therefore, saw the establishment of Development Finance Institutions (DFIs) in many countries designed to achieve this goal (Schmidt and Zeitinger 1996, pp.354-355; Yaron et al. 1997, pp.20-21). However, the lessons learned were disappointing. Their low rates of interest on loans discouraged savings mobilisation, while rationing out the vulnerable borrowers (Thillairajah 1994, p.74 and Adams 1998, p.31). Those rationed out were left with no alternative but to turn to the IFS. Diaz-Alejandro (1985, p.7) summed it up aptly that in Latin America “development banks created to solve one form of market failure, led to another one, i.e., a segmented financial market”.

However, as this policy failed, a new one emerged. The donor community that supported DFIs dumped them for bureaucracy in government and opted for NGOs. Their policy, nevertheless, remained the same, i.e., channelling subsidised loans to
priority sectors (Shylendra 1995, pp.1-2) but without involving the government. Lessons learned were not any different – notable failures of most credit programmes that accumulated large loan defaults (Thillairajah 1994, pp.56-58). Thus targeted subsidised credit to priority sectors either through FFS institutions, government owned DFIs or donor supported NGOs, promoted the fragmentation of financial markets of LICs.

2.1.3 Minimum reserve requirements

Minimum reserve requirements is a monetary policy tool that has also been used and is still in use world-wide to ensure stability of the banking system and to check money creation. In developed countries minimum reserve ratios usually lie between 10% to 15% of total bank deposits. However, in LICs the ratio can be as high as 50% (Germidis, Kessler and Meghir 1991, p.52). By imposing such high rates of reserve requirements, the domestic banking system is compelled to finance public debt thereby crowding out other needy borrowers. This policy discourages the banking system from mobilising savings. To avoid this banks are motivated to pay negative real interest rates on deposits, discouraging potential savers to save with them, who turn to other forms of savings arrangements, including informal ones thus fragmenting the sector.

2.1.4 Minimum accounts balances

Minimum accounts balances may also be used by banks to discourage savers. High minimum deposit requirements are usually beyond the majority of the working poor and SMEs, who, given their usually small money balances, reflective of very low incomes in LICs, demand deposit facilities that can accept their small deposits which FFS institutions find expensive to provide (World Bank 1989, p.112). As these requirements effectively lock them out from the services of the leading banks, most savers spill over to the IFS in search of affordable financial services.

This school concludes that in a financially repressed FFS, the incentive for FFS institutions to attract new clients is considerably reduced. Unattracted customers consequently turn to informal financial arrangements. Financial dualism therefore, is a reflection of an over regulated FFS which cannot adjust accordingly to the conditions prevailing in large parts of LICs.
2.2 A response to the dualism of the developing countries' economies

The second set of arguments explain the existence and extent of financial dualism by the dualism of the economies of LICs. Financial market segmentation, therefore, results from the dualism of economic and social structures of their economies with the IFS being its result, rather than its cause. Some aspects that describe economic dualism of these countries clarify this contention.

2.2.1 Illiteracy

The problem of illiteracy especially of the rural masses in these countries, engenders weak linkages between them and FFS institutions for which the latter bears no responsibility. For example, a study conducted in a rural Kenyan district - Siaya, showed that 72.7% of sampled respondents participated in informal financial arrangements, a finding partly attributed to the high degree of illiteracy in rural areas. The popularity of IFS participation was much stronger amongst the females with 89% sample participation compared to 49% for males (Ouma 1991, pp.57 & 60). Further results showed that being a female enhanced significantly the likelihood of IFS participation. This was attributed to, amongst others, a relatively higher level of illiteracy amongst the females. FFS institutions' need for literate and numerate customers, however, is obvious since both parties need to document their transactions in writing. Thus illiteracy easily deters potential customers from using the services of these institutions since they often feel intimidated by the personnel and complicated bureaucratic procedures of these institutions - which demand a given level of literacy to be comfortable with. Programmes that improve literacy, therefore, enhance FFS participation (Besley 1994, p.32).

2.2.2 Transportation and communications network

Poor transportation and communication networks in LICs also hinders FFS expansion (Germidis, Kessler and Meghir 1991, p.53), an aspect which, again, the FFS has no responsibility for, but is often used to partly explain its institutions urban concentration and the widespread use of informal finance in rural areas. Comparatively, transportation and communication networks in urban areas are better developed. Operating in rural areas, therefore, implies incurring high transportation
and communication costs. This discourages the location of FFS institutions in rural areas, encouraging their concentration in the urban areas, and the IFS institutions in the rural areas.

2.2.3 Concentration centres of economic activities

The concentration of economic activities at particular locations of LICs has been used too to explain the relative high density of FFS institutions in them. Such locations, usually urban centres, generate a huge demand for financial services and FFS institutions establish or branch there to tap the market, which in LICs generate most of their profits. Regions with few economic activities, therefore, have insignificant numbers, if any, of FFS institutions implying that it is the IFS that supply most of the financial needs of the population there.

2.2.4 Inequitable distribution of social services

Social services too, e.g., schools and colleges, hospitals, entertainment and even public administration in LICs, tend to be concentrated in urban centres. They, too, generate a high demand for financial services which naturally attract the profit motivated FFS institutions. Thus rural areas, where these social services are relatively scarce, have quite few, if any, FFS institutions, implying again that most of their financial services are informal.

Under such circumstances reflective of structural rigidities found in LICs, therefore, their segmented financial markets is not a product of the inefficiencies of the FFS or its excessive regulation, rather, the economic dualism of their economies. This school concludes that the economic dualism found in LICs perpetuates itself into the financial sector.

2.3 Other factors explaining financial dualism

2.3.1 Imperfect information

Financial dualism may also be explained by other factors. Information asymmetries is one such factor. Financial markets, particularly the credit component, operate inefficiently because of imperfect information (Besley 1994, p.29). The provision of credit relies a great deal on having sufficient information about borrowers' ability,
reliability and willingness to repay. The absence of reliable information, therefore, explains why lending institutions may choose not to serve some borrowers. To cover credit risk, lending institutions may increase loan interest rates. However, this can be counterproductive since the more creditworthy borrowers, arguing that loans are expensive, may refrain from borrowing. This leaves the institutions with poor creditworthy customers leading inevitably to the problem of adverse selection. In addition, borrowers may opt for riskier investments to meet the high costs of borrowing, thereby creating the problem of moral hazard. These two problems are hardly encountered by informal lenders who rely on personal knowledge of their clients (World Bank 1989, p.35) due to their close proximity, self-determination of membership and heavy reliance on social sanctions. Poor information, therefore, lead to financial market segmentation.

2.3.2 Transactions costs

Also important for FFS institutions are the costs involved, not only in collecting and processing information, but also designing, monitoring and enforcing loan contracts (World Bank 1989, p.34). Such costs which include administrative costs, mainly salaries and rent, revenue to the government, the cost of credit, and losses resulting from default are met mainly by charging interest on loans and fees on specific services. However, the costs tend to be constant irrespective of the loan amounts (Ladman 1984, p.106). Small sized, short-term loans characteristic of SMEs and poor households of LICs are, therefore, expensive for the FFS lending institutions which tend to exclude them from their credit markets.

On the other hand, borrowers also incur costs like payments for loan application documents, travel expenses, opportunity cost of time spent in fulfilling loan application procedures, etc. When they are prohibitive, borrowers get discouraged. For example, Atieno (1994, p.130), when estimating factors determining the demand for credit by farmers in Nakuru district in Kenya, found out a positive and significant relationship between non-interest costs, i.e., the costs of loan application and transportation, and the amount of credit demanded. This implies that as the costs of application and transportation increase, thereby raising borrowers transaction costs, it becomes uneconomical to seek small loans, since transactions costs form a significant proportion of the loan amounts. IFS institutions, however, keep their transactions costs low by relying on personal knowledge of their borrowers: to drastically cut down on
their information costs. Transactions costs, therefore, explain financial market segmentation.

2.3.3 Collateral

Lending institutions have, however, due to their limited abilities to identify risks in advance and monitor the behaviour of their clients, looked for ways of defeating imperfect information to reduce credit risks and make credit cheap. One of them is by demanding that borrowers provide physical assets as security. Demanding physical assets reduces information required from borrowers thereby reducing information gathering costs and inevitably transactions costs since a lender's loss is reduced to zero in default. However, in LICs such assets are usually scarce, firstly because the majority of borrowers who are poor households and SMEs lack assets that can be collateralised, secondly because of poorly developed property rights which make appropriating collateral difficult when default occurs (Besley 1994, p.33), and thirdly because most poor households and SMEs engage in service activities where physical assets are not created (Ghate et al. 1992, p.17). The poor asset portfolio of most borrowers in LICs means, therefore, that they cannot participate in the formal credit markets despite the FFS institutions intentionally demand collateral to reduce their transactions costs and make their loans cheap. For the majority, this source of cheap credit remains out of reach. They, therefore, become clients of informal credit markets which are more flexible in demanding collateral due to personal knowledge of their customers whose oral promise to repay is usually sufficient a collateral for loan (Thillairajah 1994, p.34). The demand for collateral, therefore, segments credit markets.

2.3.4 Contract enforcement

Also, even when physical assets pledgable as collateral are available, the court procedures of reclaiming them is not well established in many LICs particularly of Africa (Migot-Adhola et al. 1991, pp.155-175). Their governments become part of the loan contracts enforcement problem. For instance, their credit programmes, i.e., DFIs, experienced some of the worst default rates (Besley 1994, p.34) since while pursuing other goals like equitable distribution of wealth, they failed to strictly enforce loan repayments. Besides, most of their credit programmes, like loans issued by
government owned or controlled banks, are usually concentrated amongst powerful, politically correct borrowers who take loans without any expectation that they will be obliged to repay. Formal credit markets become jittery when such inherent weaknesses exist in the law enforcement mechanism and tend to avoid legal recourse because legal frameworks tend to be unsupportive. But even when they take them up, they become expensive and inflate their transactions costs. Therefore, they refrain from advancing loans whose prospects of repayment look gloomy. Such problems partly explain the widespread use of informal finance in LICs. The IFS overcome them by substituting for the conventional solutions to loan repayment enforcement problems, i.e., physical collateral and legal requirements, by social capital and peer pressure (Ivan and Michelle 1998, p.44). These techniques enable them to enforce loan repayments where FFS institutions fail.

2.3.5 Absence of or weak insurance schemes

These techniques that various IFS institutions employ to enforce contracts, result from close knit village, family and ethnic ties of solidarity. This in addition to the general lack or inefficiency of comprehensive insurance schemes, e.g., social security, provident funds, health insurance, etc., reinforces the mutual social insurance role that most, if not all, IFS institutions play. The weak formal insurance schemes of LICs cannot penetrate and effectively compete with the solidarity ties of informal finance thereby justifying their continued existence and dynamism. Until formal insurance schemes become readily available, affordable and efficient, they will remain unable to serve this market segment.

2.3.6 Adverse economic environment

The adverse economic environment of most LICs has put many FFS institutions, especially banks, under pressure to cut costs due to deteriorating returns. Their common targets for cost reduction have been their branch networks and human resources. In Kenya, for example, the main banks that dominate the industry namely Barclays, Standard Chartered, Kenya Commercial Bank (KCB) and National Bank of Kenya (NBK), which together command the bulk of the branch network, have been rapidly closing their branches to reduce their overhead costs and attain reasonable return on investment. Where the government had majority shares like KCB and NBK
were saturated with branches established for reasons other than economic viability. With the government's loss of majority shareholding, commercial viability dictates, necessitating branch network rationalisation. The emerging unwelcome scenario, however, is a large section of the population sidelined from mainstream banking and left at the service of the IFS.

2.3.7 Government inaction

Lastly, the IFS's continued existence and spread is seen by those who hold it in contempt to result from government inaction to interfere with it. However, the actual stance of public authorities, seen as one of non-interference, is one of neglect (Ghate et al. 1992, p.3). Nevertheless, even with direct legal measures designed to curb, curtail or displace its operations, they will not attain total success. The IFS will still exist, go underground and operate underground financial transactions. For instance, in Muslim societies where certain informal financial activities, e.g., moneylenders lending with interest, are seen as going against the ethics of religion, informal financial arrangements still exist (DeLancey 1992, p.64; Thillairajah 1994, p.25). Even the many forms of lending of some IFS institutions earlier portrayed as evil amongst many cultures never stopped them from offering their services (Adams 1992, p.7).

2.4 Critique of the arguments

Evidence shows that financial sectors of some LICs have been liberalised and financial repression considerably reduced if not eliminated. To the contrary, the IFS still exists and thrives (Germidis, Kessler and Meghir 1991, p.31; Nagarajan and Meyer 1996, p.216), doing so not only as many FFS institutions fail, but also as the FFS develops and expands (Thillairajah 1994, p.27). Financial Sector reforms, for example, already undertaken in many countries of Africa, show that efforts of the IFS to mobilise domestic resources have not been impeded as expected if it was the product of mainly repressive financial sector policies. Studies by Aryeetey (1994) in Ghana and Soyibo (1996) in Nigeria found out that deposit mobilisation by "Susu", a local rotating savings and credit association (RoSCA) name, grew rapidly even after their formal financial systems were liberalised. Further, the socio-economic principles that guide the transactions of IFS institutions do not seem to have been correspondingly changed by the financial sector reforms (Aryeetey 1996, p.217). They
have simply been adapted in accordance with the changing socio-economic environment of their clientele and changes in the national economy.

Those who argue that economic dualism perpetuates financial dualism agree as much. Dornbusch and Reynoso (1989, p.204), for instance, in their study contrasting two financial approaches to economic development - one in Asia centred on the role played by unrepressed financial markets in intermediating resources and another in Latin America centred on the role of inflationary finance and the scope of deficits to enhance economic development and growth - concluded that the usually strong claims made for the benefits of financial market liberalisation are unsupported by evidence. They noted that financial liberalisation is one of the important factors that promote major inflation. Agitating for it implies a reduction in government revenue from the process of money creation in turn implying the acceleration of inflation including, "the promotion of capital flight at the official exchange rate" (Dornbusch and Reynoso 1989, p.209), depriving the economies of the much needed investment resources.

Instead they advocate for financial market regulation by arguing that the conditions whereby financial resources may be mobilised and efficiently invested through the market forces are not yet well developed in LICs (Germidis, Kessler and Meghir 1991, p.54). They emphasise that the institutions themselves, if left free, would not adhere to the basic tenets of good management which is why they must be closely monitored, controlled and their operations verified. The narrow base of potential local investors, ready and willing to assume the role of shareholders, explains the narrowness of financial markets in LICs, underscoring the need for public sector resources and calls for financial market regulation. Besides, even in countries where financial liberalisation is being pursued, it has done little to counter the activities of informal finance.

Economic dualism, however, is also subject to criticism. For instance, better means of communication and transportation, higher levels of literacy and the high density of FFS institutions in urban centres due to the concentration of socio-economic activities, have not prevented the existence and widespread use of informal finance in urban areas (Adams and Fitchett 1992, p.3). Their impacts may be significant towards improving FFS participation but fall short of wholly explaining the dynamism of informal finance there.

In explaining financial dualism however, each of the strands of arguments, taken on its own, is insufficient. That other factors outside them that contribute to this explanation show that even together, they do not explain it fully. Nevertheless, with the other factors, they show that financial dualism is a reality in this region. But studies
show it is not only a reality, its extent is also large. A brief exposition of the extent below shows why it has attracted a number of developments into the financial sectors of many LICs.

3. The Extent of Financial Dualism in Developing Countries

The diversity of informal finance and its institutions’ poor record keeping make ascertaining the extent of financial dualism in LICs a daunting task. However, indicators reveal a larger IFS more important in intermediating funds than the FFS. Wai (1957) used the ratio of deposit money : money supply, M₂, and also the ratio of banking system’s claims on the private sector : national income for 16 LICs¹ to gauge their relative sizes. He assumed that the growth in these liabilities could only be at the expense of the IFS in terms of its size and influence in the financial markets. But he found out the opposite that the IFS was larger than the FFS in more than half of the sampled countries in Asia, Latin America and the Middle East in the 1950s. Where even the IFS was smaller, it was at least 75% the size of the FFS.

Household survey data have also been used as reliable indicators of relative sizes. Germidis, Kessler and Meghir (1991, pp.43-46) reported that in Bangladesh, the mean size of the informal credit market, measured as a percentage of credit from informal sources, approximated 60%. In the 1980s in Indonesia, 83% of agricultural households received no formal credit and 93% of households with businesses financed them from own funds. Around the same time in Thailand, 52% of loans to the agricultural sector were from informal markets. In 1986 in Malaysia, 62% of total loans to farmers came from informal sources. In the Korean Republic, it was estimated that half of the average outstanding loans of households of farmers were from informal sources and so was it in Mexico, where informal credit to farmers represented 50% to 55% of the total.

This scenario is not any different from the Africa context. Ghanaian data, between 1988 and 1989, showed that 80% of household savings were held with the IFS, either

¹ The countries were: India, Korea, Nepal, Pakistan, Philippines, South Viet Nam, Sri Lanka and Tahiland in Asia; Brazil, Chile, Costa Rica, Equador and Mexico in Latin America; Afghanistan, Iran and Turkey in the Middle East (See Chipeta and Mkandawire 1991, p.96).
at home or with its several institutions and nearly 90% of loans taken were from individuals, e.g., relatives, friends, landlords, acquaintances, etc., (Aryeetey 1995, p.12).

In Ethiopia, according to her 1968-1973 development plan, total savings mobilised by “equbs,” a local RoSCA name, was estimated at 8% to 10% of GDP (Mauri 1988; Germidis, Kessler and Meghir 1991, p.42; Bouman 1995, p.373). Aredo (1993, p.5) corroborated this later that “the great bulk of the Ethiopian population makes little or no use of the formal savings and lending institutions”.

In Malawi, Chipeta and Mkandawire (1991, pp.31-32) using two different measures confirmed the dominance of the IFS there. Using the amount of credit extended by both sectors to the private sector in 1988, they found out that credit from the IFS (K281.5 Mio.) exceeded FFS’s (K107.9 Mio.) - comprising formal and semi-formal financial institutions, implying that the IFS was larger than the FFS by more than half. Equating savings mobilised by the FFS with the change in deposit liabilities of banks and non-banks to the public and credit extended by the various IFS institutions to her mobilised savings, they discovered that the FFS’s additional mobilised savings (K72.9 Mio.) in 1989 was far much less than the IFS’s (K265.6 Mio.) in the same year, implying that the IFS was larger than the FFS by more than three times.

In Tanzania, Hyuha et al. (1993, pp.21-23) in a survey of 262 households in seven regions², found that the IFS was quite widespread. 65% of the sampled households had used both formal and informal sources of finance with 77% of the 65% having used the IFS. The story is the same in Zimbabwe, where in 1986, 87% of farmers used informal sources of credit, and in Nigeria where a survey of sampled farmers from Kwara and West Nigeria states showed that 95% of loans they received came from informal sources (Germidis, Kessler and Meghir 1991, p.42).

In Kenya too, Ouma (1991, p.57), in a survey of the IFS in a rural Kenyan District - Siaya, established that 72.7% saved with and borrowed from the IFS. Besides, only 18% had ever borrowed money from a bank indicating the widespread use of informal finance.

The widespread use of tontines in francophone African countries like Cameroon, Senegal, Cote d’Ivoire, Burkina Faso, Benin and Togo, as documented in the studies

² They were Dar-es-Salaam, Mbeya, Arusha, Dodoma, Morogoro, Musoma and Coast.

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of Miracle et al. (1980) and Seibel (1989), imply that the IFS is large in this part of Africa as well.

Using the population size participating in informal financial arrangements also show that the IFS remains large. For example, according to Bouman (1977, pp.181-182), “amongst the Bamileke of Eastern Cameroon, every adult is a member of at least one savings and credit association”. And in Western Cameroon, at least 75% of all villagers are members of one or more of these associations with such high percentages also reported in The Gambia where, membership in “kafos” - RoSCAs local name - embraces 70% of the adult population in the villages (Bouman 1995, p.372). In Benin, almost everyone above 18 years is a member of a tontine (Thillairajah 1994, p.70). Its widespread use, however, is not limited to rural areas. In Ethiopia, it is estimated that 60% of the urban population participate in “equbs” and that this figure may reach 90% amongst Craftsmen and Weavers, whereas in Zambia 80% to 90% of the urban population participate in the IFS (Germidis, Kessler and Meghir 1991, pp.41-45). In fact, for most countries of SSA, Thillairajah (1994, p.72) observed, those who do not participate in any informal financial arrangement may be badly reputed in their communities.

These studies prove that the IFS is large and its membership covers the majority in LICs. They establish that FFS products hardly reach the majority. Implied is a shortage of capital, to supplement the abundant supply of labour and land in LICs to boost its production, development and prosperity. This sparred thinking which saw a number of developments in their financial sectors.

4. Financial Sector Developments Sparred by Financial Dualism

4.1 Earlier Developments

The large extent of financial dualism in LICs, seen as the source of shortage of capital, attracted the attention of governments and donors. Special government and donor sponsored programmes were, therefore, designed to provide capital. The 1970s all through to the 1980s saw the initiation of these programmes (Krahnen and Schmidt 1994, pp.10-12; Morduch 1999, p.1570). They included the establishment of government owned DFIs, NGOs credit programmes, government directives to FFS institutions to lend a given percentage of their loan portfolios at predetermined rates to those who would not otherwise receive credit, etc. The programmes generally
relaxed collateral requirements and charged below market rates of interest resulting into a combination of costly services, inadequate security and cheap loans. This demanded huge and unsustainable subsidies. Huge subsidies aside, they achieved the opposite results funding instead large-scale enterprises of influential and rich people. Thus these attempts to keep the price of credit artificially low to enable the majority in LICs to have access to it failed, leading to new efforts being pursued to reach them with sustainable financial services.

4.2 Recent Developments – Group and Microenterprise Finance

Amongst notable recent developments in the financial sectors of LICs are the concepts of group and microenterprise finance. Group finance is the common practice of most IFS institutions today formed by groups of individuals with the objective of pooling their savings and lending exclusively to themselves, e.g., RoSCAs, ASCRAs, etc. Some like MAGs, pool resources (saved in advance or at the time of need) to provide cover for members’ domestic and business risks, whereas some borrow from other financial institutions on joint and several liability stipulations. They can be established along a geographic unit, e.g., a village or community (village or community banks), in a business centre (business association), or within a social group or organisation (mutual groups). The benefits stimulate their fast growth and push the usurious moneylenders and individual money collectors to the periphery, resorted to as a last resort. They have provided lessons to some FFS institutions which today also employ their group finance principles to offer financial services to those they would not have served. Microenterprise finance institutions are such beneficiaries.

Microenterprise finance concerns itself with both savings mobilisation and credit provision. It seeks to supply these services to the majority of SMEs and the poor using local resources (Otero and Rhyne 1994, p.11) through microenterprise finance institutions (MFIs). MFIs are based on principles with prospects of expanding the reach of the poor and SMEs to these services. They include (i) a market based understanding of the customers’ preferences and designing products to meet them; (ii) a recognition of savings as forming an important component of finance to microenterprises, financial institutions and the economy – just as credit; and (iii) insisting that only viable financial institutions provide financial services (Seibel 1996, p.85). This approach shifted focus away from the unsustainable financial programmes,
which focused only on credit, to institutions and their ability to provide financial services to the poor and SMEs sustainably.

4.2.1 Introduction of MFIs

The first MFI was established in South Asia more than two decades ago (Remenyi 1997, p.1) but today they reach over 7000 (Von Pischke 1998, p.8) and spread to Latin America, South East Asia, Africa, China and the South Pacific (Remenyi 1997, p.1.). However, most are still donor supported high cost operations. Only about 1% are considered profitable (Von Pischke 1998, p.8). Amongst the 1% is the Grameen Bank (GB) of Bangladesh established in Jobra in 1976 and considered one of the World's most successful MFI banking with the poor. As at December 1995 it had an outreach of 2.06 million members cum borrowers, 94% of whom were women and serving through 1068 branches in 36,142 villages of Bangladesh with a loan recovery rate of 98% (Seibel 1998, p.1). The model’s success inspired donors into supporting its replication in other countries with the motive of alleviating poverty.

Such replication efforts have also reached SSA. The group loan schemes of the Agricultural Development Bank and the Ghana Commercial Bank and also the Global 2000 loan schemes tried in Ghana were poor performers. So were the World Bank sponsored Lilongwe Land Development Project (LLDP) started in 1973 and the Malawian Mudzi Fund both in Malawi and both of which performed poorly once external resources were discontinued (Thillairajah 1994, p.73). Only KREP (Kenya Rural Enterprise Programme) in Kenya and ACEP (Alliance du Credit et de l'Epargne pour la Production) in Senegal are reported to have attained at least operational self-sufficiency (Nagarajan and Meyer 1996, pp.127-128). Their major failure was their formation to serve credit with exclusive reliance on external funds. Even the most poverty focused programmes committed to attaining financial independence like the GB, only manage to finance approximately 70% of their total costs (Morduch 1999, p.1571).

4.2.2 Innovation in MFIs credit provision

Most MFIs including GB Replicators accept social capital or local sanction – a lesson learned from informal finance (Von Pischke 1998, p.3) - which lowers transactions costs and apply peer pressure for screening loan applications and
recovery. Nevertheless, they do not require borrowers to present pre-existing social capital - they impose it. Normally 5 - person solidarity groups represent social capital and is presented as collateral, creating mutual responsibility for loans. Light and Pham (1998) demonstrated this aspect clearly in their study of differences between Grameen-style Microcredit and Informal Credit versus Bank Credit in USA. They found out that the key difference between these institutions in supplying credit was their orientation towards social capital. Banks neither accept nor build social capital amongst their customers, i.e., bank customers, no matter how long they operate as customers, never develop any solidarity amongst themselves. RoSCAs, however, like any other IFS institution based on mutuality, require users to present existing social capital as collateral. But MFIs open their doors to those incapable of even forming social capital on their own who are usually some of the very poor that even RoSCA type IFS institutions would not serve. The lessons learned have enabled MFIs to employ joint liability to successfully lend to their borrowers without tangible collateral and also to avoid information gathering and loan monitoring costs, activities which are performed by the group to ensure timely loan repayments by members so as to maintain continued access to future refinancing. These arrangements which lower loan transactions costs, also generate low interest rates on loans (Armendáriz de Aghion and Gollier 2000, p.632; Ghatak 2000, pp.601).

4.2.3 Performance of MFIs

The creation, development and growth of MFIs has in a way improved the accessibility of poor households to the financial services in LICs. They have become part of their financial structures but can only remain so if they achieve self-sufficiency and sustain it. Their establishment however, like DFIs before them, reflect inherent weaknesses in the financial structures of LICs that created market niches for which they were formed to serve. Banks, therefore, are not and should not be the only ones relied upon to intermediate funds (Light and Pham 1998, p.46). However, these niches were being served even before by IFS institutions, though inadequately and at times expensively. But indirectly, they were also intended to dislocate the IFS.

Surprisingly, this did not happen even with the introduction of MFIs which clothe some of their attributes like social capital and peer pressure. Nowhere other than Modhupur, a village in northern Bangladesh with a very strong presence of known
member-based MFIs such as the GB, Buro – Tangail, Caritas, Proshika, etc., is this better illustrated. Despite the increased outreach, still 87% of her households borrow from IFS institutions (Saurabh and Imran 1998, p.69). MFIs member households borrow just as much as non-member households from informal sources both for consumption smoothing and loan repayments. In fact, MFIs member households divert bigger proportions of their loans to internal and external cross-financing (Saurabh and Imran 1998, p.70) away from productive investments intended to lift them out of poverty. Thus, although MFIs endow their members with social capital enabling them to borrow from the two sources, their leading achievement has been the improvement of the nutritional standards of their members who have consistently smoothed their consumption patterns, affording three meals daily as confirmed by one GB member who said "we were always in debt, and will always remain so. At least now we can eat three times daily" (Saurabh and Imran 1998, p.71).

The achievements of MFIs in Africa are not any different. They have likewise endowed their members with social capital giving them access to both MFIs and IFS loans. Similarly, this has improved their levels of nutrition but only in the short term since they are largely financially self unsustainable. For example, the measurement of subsidy dependence index (SDI) for K-REP, Africa's probably most well known MFI, show a high level of dependence on subsidies. So are those of West Africa's, e.g. Credit Mutuel in Senegal, Credit Mutuel and Credit Rural in Guinea, etc., whose financial viability measured by ratio of total revenues (interest income, fees and interest on investments) to total expenses (all administrative costs, depreciation of fixed assets, bad debts and cost of loans) showed the majority covering only a third to a half of their operating costs (Aryeetey 1998, p.20).

Saurabh and Imran (1998, p.70) concluded that the MFI lending technology is insensitive to variations in households internal and external environments and like the banking technology is inflexible. Thus, like banks which employ a "One–Size–Fit–It–All" type of financial services (Light and Pham 1998, P.39), MFIs "place all households in a similar trademill of continuously increasing loan sizes and insist on fixed repayment schedules" (Saurabh, and Imran 1998, p.72) ignoring the variations in households' conditions, e.g., households' human and physical capital, like their sizes, structure, wealth, etc., the market imperfections they face and available economic opportunities. MFIs assume that increasing loan sizes increases benefits across all households and that they derive some benefits if loan repayment rates are high. However, they fail to recognise the double debt burden their loans
place on their members who have to borrow significantly from informal sources to meet their loans' fixed repayment schedules, to access their future refinancing.

5. Observations and Conclusions

Financial dualism, with a large IFS catering for the financial needs of the majority of the population in LICs, best describes the financial structure of most of these countries with the SFFS belonging to the FFS due to the legal attention it receives. The two strands of arguments based on repressed and deficient FFS and the dualism of the general economic structure of LICs with other factors outside the financial system, account for its existence.

The knowledge that the IFS is large, a candid acknowledgement of financial dualism, sparred a number of developments in the financial sectors of many LICs. They recognised that the FFS could not serve the credit needs of the majority thereby creating unbalanced development by leaving abundant supply of labour and land untapped. This lowered their production capacities, level of development and hindered their prosperity. The high level of poverty and the millions of enterprises that have remained small and micro in LICs, have been blamed on it.

DFIs, NGOs credit programmes, governments explicit directives to FFS institutions, liberalisation of financial markets and now MFIs, have all been intended to rectify the situation. The first three generally failed due to huge unsustainable subsidies. They provided the lesson that sustainability of credit also requires the mobilisation of savings. MFIs differed from them in this respect and were seen as a remarkable development in the financial sectors of LICs. But their performance has not been satisfactory because they have remained donor dependent. Besides, their assumptions that poor households benefit from increasingly large loan sizes and that high loan repayment rates measure their success is incorrect. Such assumptions fail to recognise the cross-financing of loans with IFS loans used to repay MFIs ones to ensure continued access to them. Such loan repayments are not generated from the enterprises they fund, rather, are acts of borrowing from Peter to pay Paul. The probability of returning the loans unused in bits for fear of defaulting can also not be overruled and their goal of poverty alleviation remains a mirage.

Most importantly, these developments in their financial sectors have not dislocated the IFS despite their imbedded attempts. Its continued coexistence is testimony to the
important role it plays in providing financial services to market segments that even MFIs, which clothe some of their attributes like social capital and peer pressure, cannot. It also provides a reflection of customer preferences for IFS services implying that there are people who are satisfied with their services and would not be easily attracted to the services of newly established institutions. For them the IFS has always been there serving their financial needs timely and flexibly, resulting in their reluctance to substitute it for the FFS no matter how subsidised or similar their services to IFS’s are. These preferences need acknowledgement and respect as new developments get introduced in the financial sectors of LICs.

The paper, therefore, has shown that financial dualism characterises the financial sectors of LICs. But developments in the sector intended to expand its outreach, neglected, ignored or assumed the IFS, ending with disappointing results. However, given its large extent, the paper warns that new developments, whether structural, institutional, policy or research oriented, etc., intended to expand the sector’s outreach, will yield further unsatisfactory results should they abate the neglect of the IFS serving the financial needs of the majority. It recommends that new developments in the sector seek to enhance its working environment by incorporating it in their plans. Thus, the key to successful financial sector development in LICs lies in recognising their financial dualism and using it to their advantage.
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Abstract

Financial dualism, entailing the coexistence of the formal and informal financial sectors, describes the financial sectors of low income countries (LICs) as explained by the strands of arguments under financial repression, the dualism of their economies and other factors. By a critical review of different strands of literature, the paper shows that financial dualism pervades the financial systems of these countries. Despite attempts to dislocate the informal financial sector (IFS), it still thrives reflecting preferences of users reluctant to abandon it in the face of introduced subsidised credit and institutions that clothe some of their attributes like social capital, peer pressure, etc. It has served the financial needs of the majority in LICs flexibly over time and is not any less important than the formal. The paper recommends strengthening it to satisfy the financial needs of those sectors of the economy which it has served. New developments should not abate its neglect, but rather strive to improve its working environment by incorporating it in their plans.