Credit Markets: Basic Problems and Past Policies

"The rural poor are ultimately penalized on both their deposits and loans by low interest rate policies. Until these policies are swept aside, it will be impossible .... for rural financial markets in low income countries to stop floundering." Dale W. Adams (1988)

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Basic Problems (circa 1950):

- Low quantity of domestic savings — major constraint on investment, especially in manufacturing

- Dualistic credit market

$\hookrightarrow$ **formal sector** — commercial and government run banks serving urban sector and large landowners

$\hookrightarrow$ **informal sector** — small scale lenders and agricultural cooperatives serving small scale rural borrowers and the informal urban sector

- Skewed distribution of credit access — a source of persistent and widening wealth disparity.

The Development Planning View

Dominant paradigm (1960s / 70s)

- Monopolistic moneylenders, especially in rural areas
- Lack of "financial depth"

$\hookrightarrow$ low savings due to uncertainty regarding potential bank failure and ineffective legal systems

$\hookrightarrow$ lack of alternatives financial assets catering to varying needs of potential savers/lenders.

Policy Strategy:

- "put the moneylender in his place" *All India Rural Credit Survey* (1950)

↪ development banks to lend at low rates to rural borrowers

- initially fill savings gap with tax revenue and foreign loans/aid
- Eventually banks would become self–financing

BUT

↪ failed to drive out informal moneylenders

↪ development banks did not become financially viable

↪ access to formal credit remained skewed towards large landowners

The Chicago School View

- Informal sector is competitive, but risky and costly due to

$\hookrightarrow$ seasonal activity

$\hookrightarrow$ systemic risk

$\hookrightarrow$ geographically dispersed customers

$\hookrightarrow$ absence of collateral — land is often untitled

$\hookrightarrow$ difficulty of enforcing repayment

$\Rightarrow$ lack of information reflects acquisition costs

$\Rightarrow$ high interest rates reflect risk not monopoly power

- Lender's risk hypothesis:

$$\text{Profit per \$ loaned} = p(1+r) - (1+i)$$

where

$$\begin{aligned} r &= \text{lending rate} \\ i &= \text{marginal cost of funds} \\ p &= \text{probability of repayment} \end{aligned}$$

$\hookrightarrow$ Competition $\Rightarrow$ zero economic profits

$\hookrightarrow$ risk–adjusted interest rate

$$r = \frac{1+i}{p} - 1$$

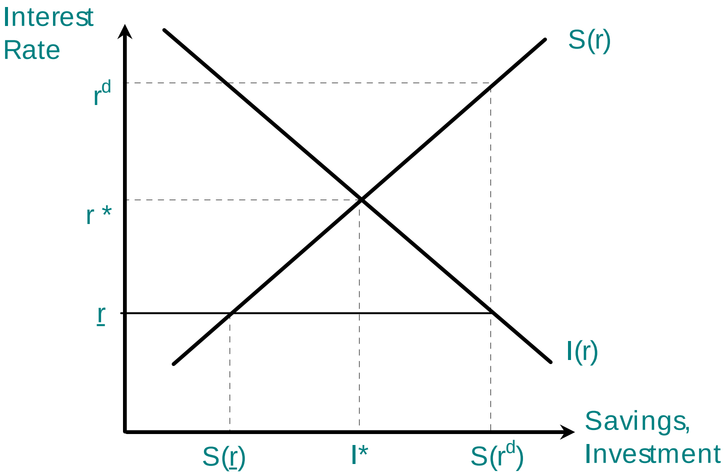

Figure: Implications of Interest Rate Ceiling

- Policy implication: government intervention is bound to fail

$\hookrightarrow$ removal of interest rate ceilings

$\hookrightarrow$ credit market liberalization pushed by external lenders

BUT

$\hookrightarrow$ localized information limits competition

$\hookrightarrow$ interest rates often *negatively* related to risk

$\hookrightarrow$ information is a **public good** — social benefits exceed private benefits

$\hookrightarrow$ no explanation for other institutional characteristics

Example 1: Credit Markets in Chambar, Pakistan

Irfan Aleem

- Informal sector $=$ 75% of rural lending
- Mean Interest Rates: Formal $=$ 12%, Informal $=$ 79%
- Non–specialization by lenders: interlinking of loan and commodity contracts
- Significant entry rates into lending
- Borrower loyalty
- High degree of duality:

$\hookrightarrow$ Informal sector: no collateral, but low default rates

$\hookrightarrow$ Formal sector: collateral but high default rates

- Significant entry rates into lending
- Borrower loyalty

Example 2: Nakhan Rachisma Province, Thailand

- Share of credit from informal sector = 56% (90% in 1975)
- Mean Interest Rates: Formal = 12%, Informal = 90%
- Small borrowers use informal sector.
- Variety of contractual relationships
- Formal "peer monitoring" system
- informal lenders' incomes co–vary with borrowers.
- Borrower loyalty and ease of entry

Example 3: Informal Sectors of West Africa

Main sources of finance in order of importance:

- Family and friends
- Moneylenders
- Suppliers' credit
- Esusus and Tontines (ROSCAs)

$\hookrightarrow$ 1/2 of rural residents in Cameroon, Cote d'Ivoire, Congo, Liberia, Togo and Nigeria

- Non–Governmental Organizations
- Credit Unions
- Banks — do not serve informal enterprises