THE SIGNIFICANCE OF LINKING INFORMAL AND FORMAL FINANCIAL INSTITUTIONS FOR DEVELOPMENT

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1. INTRODUCTION

The presence of financial markets capable of mobilizing financial resources efficiently is widely believed to be crucial for economic growth. However, the African credit markets are, in general, said to be highly fragmented. As a result, financial flows between informal and formal sectors are restricted as each sector serves only a distinct group of the society. Financial resource allocation is, therefore, inefficient in these markets because of the limited chance of mobilising financial resources from one market to another.

Both formal and informal financial institutions have their own advantages and disadvantages in financial resource mobilisation. What is impossible for a formal financial institution may be very easy for an informal financial institution. For instance, it is costly for a formal financial institution to provide loans for informal sector operators. On the other hand, informal financial institutions are unable to provide large sums of money for investors in large-scale projects.

The Ethiopian financial markets are no exception to those prevailing in the rest of most of African countries. As is the case with many developing countries, a significant portion of the country's population is said to be served by the informal financial sector. With more than 80% of the population earning their livelihood from agriculture and living in rural areas where formal financial institutions are hardly available, this dominance of the informal sector in serving the majority of the population may not be surprising. However, this dominance per se may not necessarily warrant the presence of effective financial resource mobilization. Hence, for an effective and sustainable impact on economic growth, efforts have to be geared towards making the most of each of the financial sectors. By so doing, financial integration and innovation may be possible.

Considering the importance of both groups of institutions for economic development, the need for linking informal and formal financial institutions is quite obvious. With this put in place, the process of graduation from informal sector to formal sector can be

expedited. The objective of this paper is, therefore, to review possible ways of linking the two groups of institutions for a better contribution towards development.
The paper will primarily focus on reviewing various approaches to linking informal and formal financial institutions. The significance and weaknesses of informal financial institutions will also be discussed so that the various proposals for linking the informal institutions with formal institutions will be understandable.

Side by side with the discussion on various ways of linking the institutions, the Ethiopian experience will be brought to the attention of the reader in a manner easy for reviewing the existing situation and the prospect for the future. In general, such kind of attempt will no doubt play its part in enriching our understanding about the results of the interaction between the two groups of institutions.

2. BACKGROUND

There are two major theoretical approaches in explaining financial market fragmentation (Aryeetey et al., 1997). They are:

1. Policy based explanation; and
2. Structural and institutional explanations.

The first approach is that propounded by McKinnon (1973), Shaw (1973) and Fry (1982, 1988). It stresses that financial fragmentation arises because of government policy failures, which result in repressive intervention. According to this approach, informal financial institutions are the result of excessive intervention. Hence, getting rid of restrictive government policies would do away with the need for informal finance.

The second approach, on the other hand, provides structural and institutional explanations for financial market fragmentation. The explanations focus on imperfect information on creditworthiness and cost differences in screening, monitoring, and enforcement of contract. "In the presence of imperfect information and costly contract enforcement, market failures result from adverse selection and moral hazard, which undermine the operation of financial markets" (Aryeetey et al., 1997:199). Adverse selection arises when increasing interest rate discourages viable investments from being financed (implemented) while moral hazard involves borrowing at high interest rate or with no intention of paying back. Both cases increase default.

The presence of imperfect information and cost differences in credit processing is quite obvious in developing countries. Due to underdeveloped physical infrastructural facilities, communication is restricted, thus leading to increased cost of information gathering. In addition, the low level of legal infrastructure by itself increases cost of contract enforcement. As a result, formal financial institutions are forced to restrict themselves to large-scale borrowers while excluding small borrowers from their financing operations. They try to reduce cost of contract enforcement through asking for adequate collateral. This mechanism obviously favours large-scale borrowers.

Informal financial institutions, on the other hand, make up for the institutional weaknesses of formal institutions by making use of personal relationship to tap reliable information on their small-scale borrowers. Furthermore, they manage to reduce cost of contract enforcement by making use of group pressure and other social sanctions that can stand for collateral. However, they are not in a position to serve large-scale borrowers because of limitation in their sources of finance. To maintain smooth financial flows between the two financial sectors, it is, therefore, advantageous to forge means of achieving integration. Let us pass onto reviewing the main features of informal financial institutions before discussing the linking process.

3. INFORMAL FINANCIAL INSTITUTIONS

Informal finance refers to all transactions, loans and deposits occurring outside of the regulation of a central monetary or financial market authority (Adams and Fitchett 1992; Aryeetey et al., 1997). Empirical studies show that most African countries practise informal financial activities (Aryeetey 1995). This also applies to most developing countries significant portions of whose population are engaged in micro and small-scale activities that are known to be disadvantaged in terms of having access to formal credit facilities (Ibrahim 1998). But what are the reasons for such a tilt towards informal finance by the sizeable portion of the developing world population? A wide range of reasons can be produced to answer this question. However, it is worthwhile to focus only on the major ones repeatedly emphasized by many researchers.

To begin with, most formal financial institutions in the developing world, in general, and in Africa, in particular, are not in a position to offer a wide spectrum of financial services. African formal financial institutions, for instance, are characterized by "weak resource mobilization, high credit losses, high intermediation costs, and excessive political interference" (World Bank 1994). As a result, they are not widely available to serve the badly needed objective of development.

The constrained lending capacity of the formal financial sector is not because of lack of fund but rather it is due to high transaction costs associated with screening and monitoring of small borrowers (Aryeetey 1997). It is also partly the result of cumbersome administrative procedures involved in formal lending. Also high collateral requirement and setting of minimum loan ceiling alienate the majority of the rural population and the urban micro-enterprise operators from benefiting the formal financial services. Moreover, the tendency of the formal financial institutions to concentrate in urban areas further exasperates the position of the rural population in terms of access to formal sector finance. For instance, formal agricultural credit does not reach more than 20% of the rural population (Von Pischke 1991).

The financial requirement of the disadvantaged section of the society has to, therefore, be met by the informal sector finance which "consists of borrowing and lending among individuals and firms that are not registered with the government as financial intermediaries and are not subject to government supervision" (Von Pishke 1991). In this system of finance, friends, relatives, moneylenders are active players thus making informal finance "much closer to the common man's and woman's world" (Hospes 1997).

Though often held in disdain, informal financial arrangements have proved to perform well and socially useful by serving the section of the society not served by the formal sector (Von Pischke 1991). In addition, the notion once held that informal finance is a response to " financial repression " now seems to be supplemented with another evidence that signifies the gap-filling role of informal finance in a liberalized system (Aryeetey 1995). In other words, the importance of informal finance keeps on being felt even after liberalization in a developing country. The reasons for this may be the fact that financial liberalization may not necessarily be accompanied by a situation facilitating the credit access position of all sections of the society equally. Some groups such as women, the poor, rural population may remain excluded from the formal system· procedures of access to formal sector and donor funds may become complex; socio-cultural factors may keep on encouraging informal groupings (Aryeetey 1995).

The increased recognition of informal finance is not restricted to a country. International donors (both bilateral and multilateral) are also trying to make use of the strong sides of informal financial arrangements in their efforts to support developing countries. For instance, the Bretton Woods institutions have started paying attention to such moves (Aryeetey 1995).

In short, informal financial arrangements will remain the major instrument of financial resource mobilization in developing countries as long as the situations that led to their emergence and growth keep on competing for a position in the economic and social lives of the populace. That is, they will keep on being major providers of start-up capital, working capital and expansion capital for micro and small enterprises in the presence of financial repression, macro-economic policy failures to address poverty-related problems and formal financial arrangements incapable of addressing the credit demand of the disadvantaged sections of the society.

3.1. Forms of Informal Financial Institutions

There are various forms of informal finance that could involve savings and credits with or without monetary facilities. That is, savings or credits may be conducted in the form of cash or in kind in informal sector finance. The forms range from that involving friends and relatives (who may or may not charge interest on funds they make available) to professional moneylenders usually stigmatized as charging exorbitant interest rates.

The forms of informal finance also vary from country to country or from place to place in a given country. Despite this diversity, most forms seem to share similarities. The major form of informal finance is constituted by transactions conducted among friends, relatives and neighbours. But usually this form may not involve interest charging on loans. As a result, other forms attract attention of researchers, donors and policy makers. Among the other forms of informal finance, money lending by merchants, landlords, rich farmers, shopkeepers, etc. can be cited. But, the activities of moneylenders are usually regarded as usurious and anti-development. What empirical studies, however, have come up with is to downsize the tendency of holding moneylenders in disdain (Von Pischke 1991). Studies show that high interest rates may not be the results of monopoly power exercised by the moneylenders but rather they are reflections of risks involved in informal sector financing. Where high lending risk is involved, the interest rates may be as high as they need to be. Had it not been partly for this, moneylenders' activities would not have persisted.

Rotating savings and credit associations (ROSCAs) are other forms of informal finance widely available in developing countries. These are associations formed by individuals from same area of work, or from same ethnic group or from same profession or from same area of residence, etc. and known at least to some of the founders or participants. Their major objective is saving through a process whereby each participant receives on rotation a sum of money collected from the participants regularly. The status of the participants changes from a debtor to a creditor or vice versa or to both debtor and creditor as the process heads along. The first receiver becomes net debtor, the last receiver is net creditor, while those in between become debtors at one time and creditors at another time during the rotation process.

Though different in name in various countries (*iqqub* in Ethiopia, *tontine* in Francophone Africa, *gam' iya* in Egypt, *cheetu* in Sri Lanka, to mention but a few), ROSCAs are known for being socially useful and for involving individuals from all walks of life transcending the realm of the formal financial sector.

Many more forms of informal finance can also be mentioned. For example, installment buying from shopkeepers, merchants, etc., pawning, participating in self-help associations such as idir and mahiber in Ethiopia, and informal lotteries are some of the other worth-mentioning forms of informal finance.

The various forms of informal finance have evolved from a highly traditional level (in rural areas) to a sophisticated level (in urban areas) to meet the ever-changing demands of their beneficiaries. Further, chances are that they will keep on evolving as long as their social and economic importance is not out of shape that is quite unthinkable to diminish in the foreseeable future in developing countries.

3.2. Strengths and Weaknesses of Informal Financial Institutions

Various studies have identified a number of strengths and weaknesses of informal financial forms. The works of Adams and Sandoval (1992) and Tankou and Adams (1995) can be cited in this regard. The studies highlight the savings mobilization capacity of informal financial sector indicating that every informal loan is associated with saving on the part of the lender. Saving precedes borrowing to develop goodwill. Lending starts from small amounts and gradually advances to larger amounts with improved experience to sort out credit-worthy borrowers. Though mostly not equipped with formal education, the informal financial agents have been successful in managing their portfolios, innovating financial services that suit local people and successfully evaluating market value of collateral.

The low transaction costs involved, flexibility, simple procedures understandable by any participant (regardless of educational level), and provision of funds for individuals with no option of access to formal financial services are the other strong sides of informal finance. Besides, it improves social ties through ROSCAs that also encourage thrift or likeable form of forced saving and help participants have access to funds at times of difficulty (emergency). In general, informal financial arrangements are the only means of harnessing funds from savers and transferring to investors "in rural areas in the absence of capable formal financial intermediaries (Jerome 1991).

Informal finance is not without limitations. Informal financial markets are segmented in many developing countries and hence are incapable of serving wider areas and also depend on deposits mobilized from a specific group (Aryeetey 1997). Tankou and Adams (1995) outline some weaknesses of informal financial forms, especially ROSCAs, from the standpoint of ideal financial intermediation. The limitations include inability of ROSCAs to intermediate among distantly located persons because of their size and reliance on personal relationships, thus financial gains from intermediation are lost; they cannot provide large and long-term loans; they do not allocate funds on the basis of returns to be generated by the funds because of discontinuous access to funds (i.e., funds allocated merely by lot may not reflect economic utilization).

Some of the limitations have, however, been managed to be overcome, researchers and experience in Ethiopia indicate. For instance, participants who want to get ROSCA fund before their turn arrives can get it by paying premium that can be distributed among other participants (Tankou and Adams 1995; Dejene 1993). In other cases, auction can be used to determine the participant who can get ROSCA fund before others. These and other innovations have increased the sophistication of informal finance that would pave the way for an eventual integration with formal financial sector. In the paragraphs to follow, a brief review of the Ethiopian informal sector will be made.

3.3. The Need for Informal Sector Finance

The Ethiopian informal sector was a sector that had to toil its way out of misery all on its own during the Dergue Regime that favoured the expansion of economic agents established along socialist principles. During this regime, as is well known, private ownership and economic activities by private businesspersons were so restricted that the private sector as a whole neared oblivion as an economic agent let alone the informal micro-operators.

This does not, however, mean that micro-enterprise operators were totally removed from the scene. What was practiced during that period was to promote handicrafts and small enterprises through forming co-operatives, which did not allow for private ownership of production materials. For this purpose, an agency called Handicrafts and Small Scale Industries Development Agency had been established.

However, the other micro enterprise operators engaged in trade, service rendering and others were neglected. Also credit was directed to co-operatives and alienated private micro operators. As a result, micro and small enterprises, usually upheld as being breeding grounds for budding entrepreneurial skills, had to either join co-operatives, if possible, or endure the continued pressure of communism by working alone because credit was directed to co-operatives only.

In the wake of the collapse of the Dergue regime, re-institutionalisation of market economy revived the economic importance of the private as well as the informal sectors. The informal sector, therefore, started winning attention from all corners including government, non-governmental organizations, bilateral and multilateral organizations. This tendency is believed to improve the development of micro enterprise operators, and hence their eventual transformation into formal sector operators. The current status of the informal sector of the country is discussed in the paragraphs to follow.

CSA and Ministry of Labour and Social Affairs jointly conducted an urban informal sector sample survey in 1996 and the Ministry undertook on its own another survey on the informal sector in rural Ethiopia in 1997. The combined survey results give good information on the informal sector in Ethiopia.

The survey results show that there were 730,969 persons engaged in informal (micro) activities in urban areas while the equivalent size for rural areas was reported to be 1,843,645 thus making the total size 2,574,614. The employment informal sector and small enterprises generate is said to be eight times that by medium and large-scale enterprises. Of the urban informal operators, 65% were females corroborating the fact that informal sector provides refuge for the disadvantaged.

About 50% of the urban informal operators responded that their major problem was lack of sufficient capital (which could be obtained through good access to credit–38% indicated that they wanted improvement in access to bank credit). Moreover, 68% responded that lack of capital was also their major constraint to expansion. Regarding rural informal operators, 22% of those engaged in handicrafts, 32% of those engaged in food and drinks preparation and 47% of petty traders responded that they had lack of access to credit as a major problem.

In short, the findings of the surveys clearly show that there is a substantial credit need in the informal sector that needs to be met by specialized micro financing institutions and informal arrangements.

It must have been in cognizance of the above situation and the role of the informal sector in employment creation and income generation for the poor that the Ministry of Trade and Industry (MOTI) has been working on a "National Strategy for the Development and Promotion of Micro and Small Enterprises in Ethiopia". The objectives of the strategy include (to mention some) creation of an enabling environment for micro-enterprises (also called informal activities) so that they can take charge of their own fate; creation of long-term jobs through skill upgrading and modern technology introduction; strengthening of cooperation among micro-enterprises; designing mechanisms so that micro-enterprises can participate in export market; improving access to finance.

This strategy has got a lot to contribute to the development of the informal sector by making up for the problems the sector has been faced with due to policy and institutional constraints. For instance, the incentives stated in the investment proclamation No. 7/1996 proved to have not worked out for micro-enterprise operators. They are not in a position to make use of the tax holidays and import incentives as they are far from being eligible for this kind of scheme. The lease system of land holding and other problems related to work shed availability are also among the major factors stifling the growth of informal operators into the formal sector. The strategy, coupled with the government's overall economic policy that allows for expansion of small-scale industries to interact with agriculture, is, hence, expected to some extent reduce the alienation of the informal institutions. Having discussed about the general features of the informal financial institutions, we now try to look at the possible ways of linking them with the formal sector for a better financial intermediation.

3. LINKING THE INFORMAL FINANCE 4. WITH THE FORMAL FINANCE

4.1. Possible Ways and Importance of Links

Informal savings activities in Africa are widespread but generally self-contained and isolated from those of formal institutions (Adams and Fitches 1992; Bauman 1995; and Aryeetey 1997). There is evidence of demand for external finance by enterprises that want to expand beyond the limits of self-finance but that have historically lacked access to bank credit (Aryeetey et al., 1994; Aryeetey et al., 1997; Levy 1992; Liedholm 1991; Parker, Riopelle, and Steel 1995; and Steel and Webster 1992). Better integration among different segments of financial system—formal, semi-formal, and informal—could facilitate economic development by mobilising household resources more effectively and improving the flow of financial resources to enterprises with high potential (Aryeetey et al., 1997; and Seibel and Marx 1987).

Though financial flows between informal and formal sectors are restricted and financial resource allocation is thus inefficient because there is limited chance of mobilizing financial resources from one market to the other and each sector serves only a distinct group of the society, each financial sector has its own advantages. The formal sector has the capacity of providing large amount of funds but not to the informal sector that involves high transaction costs and problems of screening and enforcement. On the other hand, the informal financial sector has the capacity of reaching market niches not served by the formal sector.

For efficient utilization of financial resources that are very scarce in developing countries like Ethiopia, the need for linking the two sectors is considerable since there is a substantial importance in making use of the advantages of both sectors for the better. Besides, the negative effect resulting from absence of a link between the two markets outweighs the benefits from specialization (Aryeetey 1997). By forging links, therefore, it is possible to reduce the size of money that stays out of the hands of banks.

Economists and policy-makers have proposed a number of ways of linking the informal and the formal financial sectors. One way is through channeling the surplus in the formal financial sector to the informal sector that has a comparative advantage of reaching the poor. This is recommended to be carried out by providing credit to the semi-formal sector (on wholesale basis) for on lending to the informal sector. If possible, direct selling of credit to informal intermediaries is also encouraged. For instance, in the Ethiopian case, iqqub, idir and other self-help associations and SCAs can be used for this purpose.

Encouraging innovative schemes and devising new formal financial instruments are also among the recommended ones. There is, however, a warning against the notion that all innovative schemes and micro-financing projects are successful if based on group lending. To this end, Beseley and Coate (1995) observe that groups involving participants connected socially are more efficient than other forms of groups.

To enhance the linking effort, governments are also required to pave the way by enacting policies and procedures that create a conducive environment. To avoid problems of stiff regulation of informal institutions, Popiel (1994) recommends a proactive approach "consisting of providing a legal, regulatory, and prudential framework that fosters, and when possible, accelerates financial market development. This framework supports the setting up of mechanisms, institutions and instruments that promote and facilitate this development as the economy grows and market functions expand". Informal intermediaries need to be allowed to grow so that their integration with the formal sector improves. As witnessed by Dejene (1993), for instance, iqqubs' relations with banks grow when they grow thus facilitating the integration process. Government efforts can also be geared towards helping the integration through fiscal methods. It may be fruitful if fiscal incentives are given to formal institutions that allocate wholesale credit through semi-formal and informal agents (Aryeetey 1997).

4.2. Brief Highlights of Links Between the Informal and Formal Sectors in Ethiopia

It is possible to encourage the link between the informal and formal financial sectors in Ethiopia. Many regard the informal intermediaries such as iqqub, idir and other self-help associations as good starting points to enhance the link between the two sectors. Some NGOs have made use of these in credit provision to the poor. For instance, ACCORD, as mentioned earlier, has made use of idirs in Dire Dawa and Addis Ababa to provide credit. Hence, it is advisable to make the most of the capacity of these intermediaries in reaching the poor.

SCAs can also be transformed into formal financial institutions if allowed to form credit union banks by pooling their resources together.

The Government has recognized the importance of the informal sector and as a result has made a number of moves to promote the sector. The proclamation (No. 40/96) providing for the licensing and supervision of micro-financing institutions is one example. Taking advantage of the above proclamation, about eleven micro-financing institutions have already been established. Most are results of transformation from saving and credit schemes initiated by NGOs. In addition to the above, the Agricultural Co-operative Societies Proclamation issued in 1994 and a proclamation issued in 1998 to provide for other forms of co-operative societies including SCAs have a lot to do with improving the integration process.

The success of the integration effort can also be reviewed using some indicators. The size of the informal sector activities can be measured using a crude indicator represented by the ratio of currency outside banks to narrow money*. Although this indicator may be crude and open to criticism, it could be a good starting point in the absence of other reliable data and method. The following table shows the trend of the size of the informal sector thus obtained.

Table 1. Size of Informal Sector as Measured by Ratio of Currency Outside Banks to Narrow Money

Year	Currency Outside Banks	Narrow Money (Million Birr)	Ratio (%)
1986/87	1743.5	3563.5	49
1987/88	1908.3	3910.8	49
1988/89	2181.8	4174.4	52
1989/90	2736.3	4990.0	54
1990/91	3817.4	6131.7	62
1991/92	4315.6	6845.1	63
1992/93	4885.0	7711.9	63
1993/94	5158.9	8373.2	62
1994/95	5843.3	9909.0	59
1995/96	5692.3	9561.5	60
1996/97	5236.6	10073.9	52

Source: National Bank of Ethiopia, Quarterly Bulletin, Vol. 12, No. 4, Fourth Quarter, 1996/97.

As shown in the above table, the ratio of currency outside banks to narrow money showed an increasing tendency during the period before reform (before 1992/93) while it showed a decreasing tendency during the reform period. This can show us that informal operators were alienated from the formal sector more and more while after the reform the ratio started showing a decreasing tendency implying the emergence of integration of the two sectors. This may to some extent support the belief that informal finance is the result of financial repression. In addition, it may also,

*The size of the informal sector measured by the ratio of currency outside banks to narrow money may seem misleading for a country like Ethiopia where it may not be strange to observe informal transactions involving mediums of exchange other than currency. The reason for using this indicator is, however, based on the fact there are no reliable and exhaustive data on the informal sector that may allow the formulation of a more dependable measure.

to a limited extent, lessen the fear observed by some (see for example, Aryeetey 1995) that informal finance grows faster than formal finance after liberalization.

5. CONCLUDING REMARKS

The Ethiopian informal sector is regarded to be of considerable size increasing employment and posing great need for credit. The need is, therefore, required to be met through development of micro-financing institutions, expansion and sophistication of the informal sector finance and increased integration of formal and informal financial institutions.

As observed in the earlier discussions, the integration of informal and formal financial institutions of Ethiopia seems to have already started one way or another. What is required is to step up the integration process by enacting conducive policies to this end. By so doing, it is expected that the Ethiopian financial sector will be given a good impetus.

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