M A S

Palestine Economic Policy Research Institute

Informal Finance and Lending NGOs in the West Bank and Gaza Strip

Osama Hamed

In collaboration with

Samia Al-Botmeh **Fause Ersheid**

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P.O. Box 19111, Jerusalem and P.O. Box 303, Ramallah
Tel: ++972-2-9987053/4, Fax: ++972-2-9987055, e-mail: MAS@planet.edu

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Author:
Osama Hamed, Senior Visiting Research Fellow, MAS.
In collaboration with:
Samia Al-Botmeh: Research Associate, MAS
Fause Ersheid: Research Assistant, MAS

Arabic translation: Sami Kilani

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Abstract

This study investigates the role of the informal financial sector and lending Non-Governmental Organizations (NGOs) in the West Bank and the Gaza Strip (WBGS). It considers the scope and extent of coverage of informal finance and the developments that have taken place since 1993 with the expansion of the formal financial sector.

The study finds that despite the recent expansion of the WBGS banking system, financial intermediation in the WBGS is still very limited. While the sharp growth in bank branches has resulted in a rise in bank deposits of more than 600% in the period 1993-1997, bank lending has expanded at a much lower rate, resulting in a loan-deposit ratio of only 25%. In this environment, informal finance has continued to play an important role. Semi-formal finance, represented by lending NGOs, has also been a significant source of loans.

A MAS survey conducted in June 1996 showed that 38.6% of people over the age of 18 in the WBGS obtained or extended informal sector credit. Lending NGOs also represent an important source of credit for groups underserved by the formal sector. The MAS survey showed that 2.3% of people over 18 received credit from NGOs, compared with 7.4% from commercial banks. The relative importance of the informal sector in the credit market is even higher. Trade finance and loans from friends and relatives are common and lending by moneychangers is a major source of loans for both households and firms. Of those covered by the survey 27% borrowed from friends and 1.6% obtained credit from moneychangers.

To increase the effectiveness of both the formal and informal sectors, commercial banks could use NGOs and ROSCAs (Rotating Saving and Credit Associations) to channel funds to borrowers. Such an arrangement would reduce transaction costs, and hence facilitate bank lending by screening loan applicants and collecting loan payments. Financially sound NGOs and ROSCAs can also augment bank lending by guaranteeing bank loans or obtaining loans from banks to be lent on to targeted groups.

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Foreword

This paper on the role of the informal financial sector is one of a series of studies conducted by the Palestine Economic Policy Research Institute (MAS) on a feasible social security and welfare system for Palestinians in the West Bank and Gaza Strip. This particular study is the fifth within this series and represents a first step towards understanding the extent and scope of financial intermediation in the WBGS. Linking the informal sector to the formal banking system has important implications for the design of future policies on social security.

Other studies already published in this series are: *Informal Social Support (non institutionalized) in the West Bank and Gaza Strip, The Formal Social Support System, Living Standards in the West Bank and Gaza Strip, and The Workplace as a Source of Pension Benefits and Health Insurance in the West Bank and Gaza Strip.* A sixth study forthcoming will draw conclusions from all five studies and will present a proposal for a social security and welfare system suitable for the Palestinians in the WBGS.

I trust that policy makers will find this study particularly useful. As the first study of its kind in Palestine, I also expect it to prove of interest to researchers.

Nabeel Kassis
Director

List of Abbreviations

ADCC	The Arab Development and Credit Company
BGP	Bank Guarantee Program
EDG	The Economic Development Group
GSLP	Group Solidarity Lending Program
JD	Jordanian Dinars
IOUs	I Owe You
MAS	Palestine Economic Policy Research Institute
MECP	Microenterprise Credit Program
MLP	Microenterprise Lending Program
NGO	Non-Governmental Organization
PDF	Palestinian Development Fund
PMA	Palestinian Monetary Authority
PNA	Palestinian National Authority
NIS	New Israeli Shekel
ROSCA	Rotating Saving and Credit Association
SGLP	The Solidarity Group Lending Program
SSEP	Small Scale Enterprise Program
TDC	The Arab Technical and Development Corporation
UNRWA	United Nations Refugee and Work Agency
US $	United States Dollars
WBGS	West Bank and Gaza Strip

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1. Introduction

The purpose of this paper is to examine the role of the informal financial sector and lending Non-Governmental Organizations (NGOs) in the West Bank and the Gaza Strip (WBGS). The present economic environment in the WBGS is highly unpredictable. In addition, formal financial sector lending in the WBGS is very limited despite the recent expansion of the domestic banking system. In such an environment, the informal financial sector plays a significant role in deposit mobilization and the provision of credit.

A MAS survey conducted in June 1996 showed that 38.6% of people over the age of 18 in the WBGS obtained or extended informal sector credit. Lending NGOs also represent an important source of credit for groups underserved by the formal sector. The MAS survey showed that 2.3% of people over 18 received credit from NGOs, compared with 7.4% from commercial banks.

This paper is not meant to be an exhaustive study of informal finance and lending NGOs in the WBGS. Its goal is to highlight their importance to the economy and to stimulate further research on this important issue. One significant topic which is not addressed here is the role of informal finance in the different sectors of the economy. Such a task would require detailed micro data that is not presently available.

Lending NGOs were the main source of credit in the WBGS in the 1980s and early 1990s. Their relative importance in the WBGS credit market has declined over the past four years as a result of the expansion of the banking system and competition from PNA institutions for donor funds. Nevertheless, NGOs still represent an important source of credit, especially for borrowers who lack collateral acceptable to the commercial banks.

Informal finance played a major role in the WBGS between 1967 and 1993 when Israeli restrictions placed constraints on the presence of formal financial institutions. All banks operating in the WBGS were closed down soon after the Israeli occupation in 1967. No Arab bank was allowed to open in the WBGS until 1980, when the Bank of Palestine won the right in the Israeli Supreme Court to reopen a branch in the city of Gaza. By the end of 1993, 13 bank branches were operating in the WBGS, 8 of which belonged to the Bank of Palestine. The rest were branches of the Cairo-Amman Bank, a Jordanian bank which was first permitted to open in the WBGS in 1986. In addition to Arab banks, some Israeli banks opened branches inside the WBGS but most of these were forced to close down during the 1987 Palestinian Intifada. In any case, deposits at Israeli banks tended to be very limited since most Palestinians shunned them and credit extended by these banks was minimal.

The WBGS banking system has expanded substantially over the last four years. By June 1997 there were 80 bank branches, compared to 13 at the end of 1993. In the same period, bank deposits rose from $219 million to $1,788 million, an increase of more than 600%. Yet, despite this expansion, lending by commercial banks is still very limited. At the end of June 1997, the loan-deposit ratio in the WBGS banking system was only 29%. The main factor inhibiting lending by banks is the limited availability of physical collateral due to Israeli restrictions on land registration, plus some other institutional barriers. As a result, the informal financial sector, which does not require physical collateral for its loans, continues to play a substantial role in the WBGS credit market, along with the lending NGOs.

The informal financial institutions can be divided into two main categories; autonomous and reactive. Autonomous financial institutions came into existence long before the formal financial sector and in many developing countries coexist alongside it. However, autonomous institutions tend to be weakened as the penetration of the formal sector increases. Reactive institutions, on the other hand, develop to avoid strict government regulations in the formal financial sector. The most common examples of reactive financial institutions are finance companies like those which emerged in many developing countries in the 1970s and 1980s in response to credit control measures, such as interest rate ceilings, imposed on formal sector institutions. Examples of autonomous informal institutions include moneylenders, pawnbrokers and rotating saving and credit associations (ROSCAs).

As in other developing countries, moneylenders play an important role in informal finance in the WBGS. Yet, unlike other developing countries, borrowing from moneylenders in the WBGS is as common in urban as in rural areas. The ability of moneylenders to operate in urban areas is attributed by this study to the fact that most WBGS moneylenders are also moneychangers, which enables them to obtain information on potential borrowers as a byproduct of other economic activities, such as changing money and check cashing. Other major forms of informal finance in the WBGS are borrowing from friends and relatives, ROSCAs, trade credit, and borrowing from moneylenders.

Unlike some other developing countries, government regulations are not a factor in the demand for informal financial services. Nor does the degree of formal sector penetration seem to be important either. Economic uncertainty and limited formal sector lending, on the other hand, are significant factors. The importance of uncertainty as a variable in explaining the demand for informal sector services is apparent in the relatively high incidence of borrowing from moneychangers or from friends and relatives among WBGS workers in Israel, whose income is highly erratic due to frequent Israeli border closures. The significance of limited formal sector lending as an explanatory variable is indicated by the high incidence of ROSCA membership, as well as borrowing from moneychangers and from friends and relatives, among individuals who apply for bank loans, particularly those who are denied such loans.

Like other developing economies, a significant portion of the funds used in informal sector credit in the WBGS originate in the formal sector. In addition, postdated checks written against accounts at commercial banks are widely used as collateral for informal sector loans. The channeling of formal sector funds to borrowers through the informal sector is illustrated by this study to be a desirable link between the two sectors that should be encouraged by policy makers. The use of postdated checks as informal sector collateral, on the other hand, is a source of instability to the banking system and should be discouraged.

Section 1 of this paper discusses the main features of informal finance that enable it to serve those groups beyond the reach of formal finance. Sections 2 through 5 examine in some detail the main informal sector institutions, including their roles in the WBGS. Section 6 discusses the role of NGOs in channeling public and foreign aid funds to groups underserved by the formal sector. It also investigates lending NGOs in the WBGS, including their adjustment to recent changes in the political and economic environment. Section 7 summarizes the main findings of the paper and explores policy options which could enhance the roles of informal and semi-formal finance in the WBGS.

The main source of data on informal finance used in this paper is a random survey conducted by MAS in June 1996 as part of the social security research project, referred to henceforth as the MAS survey. The survey sample consisted of 1,400 individuals over 18 years old chosen randomly from 80 locations throughout the WBGS. Additional data on informal finance was obtained from discussions with selected providers. Data on NGOs which extend credit was obtained directly from those institutions themselves.

2. The Place of the Informal Sector in the Financial System

It is difficult to make a clear distinction between the formal and informal financial sectors. The two form the opposing ends of a continuum, with a gray area in between. Informal and formal finance are usually distinguished by the degree of government regulation. In the formal sector, government regulation tends to be extensive, while in the informal sector it is usually nonexistent or very limited.

Formal financial institutions are divided into two major categories; depository institutions and contractual saving institutions. The most common depository institution is the commercial bank. Contractual saving institutions include pension funds and insurance companies. Informal sector institutions can be either autonomous or reactive. Reactive informal institutions develop to avoid government regulations in the formal sector. The best known example of reactive informal finance is the unregulated finance companies which came into existence in many developing countries in response to interest rate ceilings. In Egypt, finance companies attracted substantial deposits in the 1970s and 1980s by promising much higher returns than the formal sector without paying explicit interest, thus appealing to Muslims who object to interest payment on religious grounds. In Pakistan, finance companies were able to mobilize deposits equal to 12% of formal sector deposits in just a few years in the late 1970s and early 1980s (Christen, 1992). In the Dominican Republic, finance companies accounted for 20% of total credit in the 1980s (Christen, 1992). Many of these companies were affiliated with mortgage banks, which are subject to regulation by monetary authorities.

Autonomous informal institutions have existed long before the formal sector and coexist alongside it in developing countries. However, autonomous informal institutions tend to shrink as the penetration of the formal sector increases. These institutions can be divided into four groups: **First**, occasional providers of financial services giving deposit and/or credit services on an irregular basis. The most common example is borrowing from family and friends and the placement of household savings with them. **Second**, regular providers of individually based financial services, such as moneyguards, moneylenders and pawnbrokers. **Third**, providers of interlinked credit, which provide credit in conjunction with other economic products and services. The main forms of interlinked credit are trade credit and producers' credit. **Fourth**, providers of group finance. Some of the institutions that fall under this category, such as ROSCAs, provide deposit facilities as well as credit services.

Formal institutions are usually concentrated in urban areas, which limits the access of rural residents to these services. These institutions often require a minimum balance to open a deposit account, hence making this option inaccessible to small savers. On the credit side, the formal sector usually deals with borrowers uniformly, which limits access to some sectors of society, particularly in developing countries. Certain procedures must be followed before a loan can be extended and, as these procedures carry fixed transaction costs for both the borrower and the lender, small or short term loans are relatively expensive and often not viable. Restrictions are usually placed on loan use. All loans have to fit into standard maturities, which may not coincide with clients' needs. Repayment schedules tend to be inflexible and are not generally responsive to unexpected changes in the financial circumstances of the borrower. In the absence of prior knowledge about the loan applicant, formal sector institutions spend substantial resources on collecting information about the applicants through personal interviews, examination of records provided by them, and visits to their businesses. To minimize losses in case of default, formal institutions usually require applicants to provide collateral with a proven market.

In contrast, the informal financial sector does not usually require physical collateral. Insider information available to informal sector lenders through daily contacts, social interaction or relations in other markets reduces the need for collateral. In addition, the informal sector utilizes a number of collateral substitutes to minimize default. These include social sanctions, third party guarantees, tied contracts, cultivation rights and the potential denial of future credit.

The informal sector has low transaction costs, which include information, administrative, monitoring and enforcement costs. Firstly, informal sector institutions are not usually subject to government regulation and their businesses are owner-managed. Hence, they can avoid costly bureaucratic procedures and administrative costs without having to worry about the agency problems experienced by formal sector institutions which are not owner-managed.[1] Another factor that lowers administrative costs is the absence of collateral. This eliminates the costs of collateral appraisal, safekeeping and documentation. Secondly, the informal lender usually has a small number of borrowers with whom he builds up a long-term relationship and can obtain information on them in a social context or via commercial relations developed through other transactions. Hence, the cost of collating information in the informal sector is low. Thirdly, the cost of monitoring is low since it is done on a daily basis as a byproduct of operating in the same social or commercial environment as the borrower. Finally, enforcement costs are minimized through collateral substitutes. Low transaction costs give the informal sector a comparative advantage over the formal sector in small short term loans. This comparative advantage applies as long as the informal sector agent limits his/her activity to a small number of customers in a limited geographic area.[2]

Unlike the formal sector, informal sector lenders do not usually place restrictions on loan use. Their loans are used for investment in income-generating activities as well as for consumption so as to smooth fluctuations in income. Loan applications are usually processed in a matter of days as opposed to weeks, even months, of processing time in the formal sector. The loan repayment schedule is much more flexible than the

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[1] Any time the workers of an economic enterprise in a market economy are not the same as the owners, some monitoring costs are incurred, if shirking is to be avoided. If the enterprise is not managed by its owners, which is usually the case in stock holding companies, additional monitoring costs are incurred because of the need to ensure that management runs the enterprise in a way that serves the best interests of the enterprise owners. The costs associated with the separation between the owners of the enterprise and management and workers are called agency costs. These costs increase with the size and complexity of the enterprise.

[2] The lending capacity of the informal sector is also limited because informal lenders usually rely on their own resources as the main source of loanable funds.

formal sector. The payment schedule is usually synchronized to the borrower's cash flow patterns. Except for loans from family and friends, interest rates charged by informal lenders are usually significantly higher than the formal sector. Part of the difference can be explained by the fact that informal sector loans tend to be smaller in size and shorter in maturity than formal sector loans, which increases the transaction cost per unit. The interest rate differential also reflects the higher risk and the change in seasonal demand. However, this does not rule out monopoly. Some monopoly rent may exist, even in communities that have more than one informal lender because of market segmentation.[3]

2.1 The Informal Sector in Developing Countries

The informal financial sector plays an important role in most developing countries. The demand for informal sector services in such countries may be driven by the attractiveness of its services, the limited knowledge of customers about the formal sector, for the relatively high transaction costs of services provided by the formal sector. It may also be induced by the limited supply of formal sector services due to institutional factors. Many developing countries do not have proper accounting standards, thus limiting the value of records provided by loan applicants as a source of information about their credit worthiness. Some developing countries do not have a legal system that allows lenders prompt access to the collateral should default take place. Others have credit control measures in place, such as interest rate ceilings which limit the supply of funds for credit to the formal sector and hence formal credit, particularly during inflationary periods. In such an environment, access to credit by large sectors of society, in particular the unemployed, tenants and entrepreneurs, becomes limited. Small firms are also adversely affected by the limited availability of formal credit, particularly those in sectors such as services, which do not generate fixed assets that can be used as collateral.

Until recently, policymakers in many developing countries held a negative attitude towards the informal sector. In the 1950s and 1960s, officials in some countries regarded the informal sector as an obstacle to economic development that should be banned or competed out of existence by government-owned development banks. Since then, official attitudes have changed substantially. Policy makers in developing countries are now more appreciative of the role played by the informal sector and some of its practices are being emulated by government lending programs. Hence, at present, informal sector regulation in most developing countries is minimal. While some countries require certain informal agents, such as pawnbrokers, to register with the authorities, the paperwork tends to be simple. Although usury laws are still in place in some countries, these are rarely enforced. Restrictions are more common as regards deposits because of the need to protect depositors and to control money supply.

[3] Monopoly rent refers here to extra interest charged by lenders because borrowers do not have access to alternative sources of loans.

The role of the informal financial sector in developing countries is particularly strong in the credit market. Informal credit accounts for two thirds of the rural credit extended in India and Thailand, one to two thirds in Bangladesh and more than two thirds in the Philippines. In the urban sector, its share in total credit is 45% in the Philippines and 57% in India. Its share in the number of loans in both urban and rural sectors in these countries is even higher because informal sector loans tend to be much smaller than loans extended by the formal sector. In some countries, the informal sector also plays a major role in saving mobilization.

In many developing countries, the informal and formal sectors operate side by side. The informal sector specializes in small short-term loans, leaving large long-term loans to the formal sector. The informal sector has a comparative advantage in financial intermediation if agents with excess funds and those with demand for funds are in the same community, while the formal sector has the edge if they are long distances apart.

The formal and informal sectors in developing countries tend to complement each other. The informal sector deposits its excess funds in the formal sector. Informal sector agents may also borrow funds from formal sector institutions and lend these funds. A bank in Malaysia, for example, extended loans to 200 tobacco manufactures to then lend on to about 180 farmers (Ghate, 1992). Formal sector loans may be channeled through groups that already serve other functions. Banks in Bangladesh lend to handloom weaver associations, which then lend to and collect loan payments from members (Ghate, 1992). Banks in other developing countries lend through ROSCAs. When the formal sector channels funds to borrowers through the informal sector, the latter normally screens the loan applicants and collects loan payments. It also bears the default risk. The formal sector lender may provide the informal sector agent with general lending guidelines but does not usually require detailed documentation on individual loans.

In some developing countries, the practices of the informal sector have been emulated by formal sector institutions. Commercial banks in rural areas began decentralizing their operations in rural areas, setting up village units to be close to borrowers. They also began to hire bank managers from within the area of operation of the branch and allowed them to stay long enough on the job to acquire an intimate knowledge of their clientele. Some rural banks resorted to village elders as a source of information about potential borrowers.

3. Interlinked Credit

3.1 Main Features

Interlinked credit can be in the form of trade credit, supplier credit, landlord credit, or credit to hired labor. The interlinkage facilitates lending to households and firms that have little access to formal sector credit because of the lack of physical collateral. It also reduces the cost of information about the borrower because of the ability of the lender to utilize information links developed over time through contractual arrangements or commodity transactions. Finally, it helps to reduce the probability of default because the desire to maintain a relationship in another market provides the borrower with a strong incentive to repay his loan.

Credit to hired labor, usually provided to workers off-season to be paid later through labor services, ensures a dependable supply of labor. Landlord credit aims to encourage the use of some desirable inputs such as fertilizers and improved varieties of seeds. Trade credit is motivated by the need to stake a claim on the borrower's output, if the credit is from distributors to producers, or the desire to increase market share, if it is from wholesalers to retailers or from retailers to consumers.

Retail credit tends to be much more common in rural than urban areas because information on customers is easier to obtain in the former. Credit by suppliers is particularly important for small manufacturers. Credit by producers is common among artisans, where product individuality makes it necessary for buyers to pay a significant portion of the price in advance. It is also widely used in agriculture, where a farmer can obtain a loan by agreeing to sell his crop in advance to the credit provider, who is usually a distributor. In Pakistan, 40 to 50% of the paddy produce is sold in this way (Ghate et al, 1994). In the Sudan, a survey of tenants with 5-20 feddans in the Kordofan province showed that 80% of sorghum farmers, 45% of wheat farmers and 35% of groundnut farmers obtained credit through the advance sale of crops (Kevane, 1993).

Some of the funds used to provide suppliers and trade credit originate in the formal sector. In Somalia, the wholesale market secures credit from the formal sector, lends it on to village retailers, who in turn extend credit to customers. In the Philippines, footwear manufacturers receive credit from suppliers, who in turn obtain credit from leather manufacturers who have access to formal financial sector credit (Ghate, 1992).

Interlinked credit can be with or without interest. If it is with interest, the interest charged is usually built-in by making an adjustment to the price of the commodity or the service associated with the interlinked credit.[4] In a study on supplier credit in the footwear industry in the Philippines, where 80% of inputs are bought on credit, Lamberte found that prices of sales on credit were higher than cash prices in only 22% of the sample. Among those who charged higher prices for sales on credit, the price differential averaged 7% (Lamberte, 1992). In the Dominican Republic, a survey of

[4] This enhances its appeal to people who object to explicit interest payment on religious grounds.

output prices paid by agribusinesses to farmers receiving credit advances showed that 55% received going market prices, while 35% said that they were paid lower than market prices, implying interest charges. In the Kordfan region of the Sudan, the purchase price of output from farmers who received credit from the buyers averages around 50% of the market price (Kevane, 1993).

3.2 Interlinked Credit in the WBGS

Trade credit from wholesalers to retailers is very common in the WBGS. Such credit is usually for a two to three month period and is backed by post-dated checks. Credit from suppliers also plays an important role in some industries in the WBGS. Vendors of chicken feed and other inputs used by chicken farms sell to their clients on credit, provided the farmers agree to sell fattened chickens to the vendor a few months down the line at a set price, agreed upon in advance. A similar agreement is known to exist between sheep farmers and their input vendors. Discussions with business people indicate that funds used by wholesalers and suppliers for credit are often obtained from commercial banks, where these groups have easier access to credit than retailers and producers because they are more likely to own assets acceptable to commercial banks as loan collateral.

The importance of supplier and wholesale credit in the WBGS was apparent in the MAS survey, which found that 13.1% of business people obtained credit from a supplier and/or wholesaler. The figure is higher in the West Bank (14.4%) than the Gaza Strip (10.9%). In the WBGS, two thirds of business people who obtain credit from suppliers and retailers use post-dated checks as collateral.

Retail credit is also common in the WBGS. The purchase of goods on credit from the local shopkeeper is a long-standing tradition, particularly in rural areas. It is also common for large ticket items, such as cars and refrigerators, to be purchased on credit. According to the MAS survey, credit sales accounted for 10.4% of car purchases, 12% of electrical appliances and 11.2% of furniture sales. Of those who purchased cars on credit, 73% used post-dated checks as collateral. Comparable figures for electrical appliances and furniture were 62.5% and 64%, respectively.

Credit by shopkeepers is usually denominated in new Israeli shekels (NIS) and is normally extended for less than one month. If the debt is not paid within a month or so, it may be converted into Jordanian Dinars (JD) or US dollars, particularly in periods of high Israeli inflation as in the late 1970s and the first half of the 1980s. Credit provided by shopkeepers is usually interest-free. Credit for the purchase of large ticket items is usually extended for a period of six months to a year with an interest rate of around 2% a month, which is comparable to the interest rate on overdraft facilities provided by commercial banks. This indicates that this credit is provided to facilitate sales and increase market share and not to generate interest income for the vendors. As a security for the loan, the vendor usually requires a promissory note or a post-dated check.

4. Rotating Saving and Credit Associations

4.1 Main Features

The Rotating Saving and Credit Association (ROSCA) is one of the most common forms of informal group finance. Other forms include saving associations, lending groups, and mutual assistance groups. Saving associations collect small funds from members to be deposited in the name of the association at a commercial bank. They do not usually extend loans to members but may be involved in input purchases and/or output marketing. Lending groups collect surplus funds from members to be used as loans to non-members or to start a business, such as a store. Mutual assistance groups collect funds to be used in activities that serve community needs, such as weddings, funerals and religious celebrations.

The ROSCA is made up of a small group of people who pay a specific amount of money into a kitty at a regular interval. The kitty is then allocated to members in rotation until each member receives the kitty. The cycle varies from a few months to several years.[5] The ROSCA promotes both saving and credit.

The ROSCA facilitates saving by making the contribution coincide with each member's wage cycle. It also provides the member with a structure that disciplines him/her to save. Once enrolled, there is an element of compulsion to continue saving and the member may have to cancel planned expenditures to do so. If the member misses payments, he/she cannot receive his/her contribution until the end of the cycle, if at all.[6]

The credit obtained by the member is determined by his/her saving capacity, which is equal to his/her future contributions. Early recipients of the kitty obtain credit from other members of the ROSCA. ROSCA members often use their kitty to acquire consumer durables. By joining a ROSCA, the member can acquire a big ticket consumer durable much earlier than by buying it with his/her own savings.[7] Evidence on the role of ROSCAs in the diffusion of consumer durables was provided by Besley and Levenson using data from Taiwan (Besley and Levenson, 1996).

Members of a ROSCA usually come from similar backgrounds, have similar interests or work in the same place. These links between members help reduce the ROSCA's transaction costs and lower the default risk.[8] The pattern of deposits and withdrawal at the ROSCA are known in advance, eliminating the need to maintain costly reserves.

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5 Multi-year cycles are not uncommon in some Asian countries. In India, the cycle is limited by law to seven years. (Von Pischk, 1992).

6 In some rural ROSCAs, contributions are suspended or reduced in non-harvest seasons.

7 If 12 people form a ROSCA to buy refrigerators, eleven of them will be able to buy their refrigerators by the eleventh month. Without the ROSCA, none will be able to acquire the refrigerator before the end of the twelfth month.

8 ROSCA membership may also strengthen such bonds by promoting social interaction between members. In Cameroon, for example, the recipient of the kitty is expected to invite other members for drinks. (Shieder and Cuevas, 1992). In Bolivia, some office ROSCA members get together for lunch every time there is a distribution.

The contributions are usually collected and handed to the recipient in the same meeting, eliminating the need for asset management.

ROSCAs can be either individual or business-based. Members of individual ROSCAs rely on their own funds for contributions to the ROSCA. Business ROSCA members, on the other hand, often borrow from the formal sector to contribute. In Thailand, for example, 55% of subscriptions to business ROSCAs come from the formal sector (Ghate, 1992). The allocation of the kitty in individual-based ROSCAs is usually done by lottery or consensus. In contrast, the allocation in business-based ROSCAs is done through bidding, with the discount on the kitty being the implicit interest rate.

Some ROSCAs are established initially as vehicles to help someone in need, usually the person who launches the ROSCA and receives its first kitty.[9] Others are formed and managed by professional organizers receiving commission,[10] or management companies. As they become more sophisticated, some ROSCAs convert into formal sector institutions. The conversion becomes more common as the financial market of the country in which they operate becomes more integrated, as was the case in Japan in the early twentieth century.[11] However, if financial integration takes place in the saving but not credit market, bidding-based ROSCAs may continue to play an important role in the financial system.

ROSCAs have a strong presence in many developing countries. In Taiwan, the participation rate is 68%, according to one household survey, and 85% according to another (Belsey and Levenson, 1996). In Korea, a 1976 survey showed a rural participation rate of 65% (Ghate et al., 1994). Surveys in the Philippines and Gambia show participation rates of 18% and 20% respectively.

Total membership in a ROSCA is usually small. In Niger, for example, it ranges from 4 to 40 individuals (Graham, 1992). In Bolivia, the average size is ten (Adams and Canavesi, 1992). In rural Egypt, it is 35 (Baydas et al., 1995). The frequency of collection varies with cash flow patterns. It could be as short as a day, such as the case with shoe shine boys in Addis Ababa (Von Pischke, 1993) or as long as a year or more.[12]

ROSCAs are usually more common in urban rather than in rural areas. They are particularly popular among women, who are usually under-represented in the formal

[9] When ROSCA members in rural Egypt were asked about the reason for joining, 55% cited the need to help someone in need. (Baydas et al., 1995).

[10] As payment for his/her service, the professional organizer may receive a share of each collection, averaging in Bolivia around 10% (Adams and Canavesi, 1992). Alternatively, he/she may be the first to receive the kitty, or not be required to contribute.

[11] A savings and loan association similar to present day ROSCAs, called Kius, began operating in Japan in the fourteenth century. By the early twentieth century, shares in Kius were bought and sold, which represented the first step towards conversion to formal financial institutions. (Izumida, 1992).

[12] A survey covering 3 provinces in Cameroon found that 43% of ROSCAs make monthly collections while the remaining collect contributions on a weekly or bi-monthly basis (Graham, 1992). In rural Egypt, the average ROSCA meets 1.5 times a month, according to a recent survey (Baydas et al, 1995).

sector. They are most popular among clerical workers and central market vendors. However, ROSCAs have a presence in different sectors of society. In Bolivia, for instance, ROSCAs were organized by a commercial bank to enable members to put downpayments on house loans, and by car dealers and furniture stores to increase sales (Adams and Canavesi, 1992). In some countries, even bank employees form ROSCAs (Baydas et al., 1995).

4.2 ROSCAs in the WBGS

ROSCAs have a strong presence in the WBGS. According to the MAS survey, 11.6% of people over 18 are ROSCA members. The average ROSCA in the WBGS has 13 members. The ROSCA's kitty is usually allocated by lottery, even though some ROSCAs allocate the kitty through consensus and the agreed-on order of allocation is sometimes changed to accommodate emergencies experienced by members.

ROSCA membership is higher in the West Bank (12.8%) than in the Gaza Strip (9.6%). It is higher in urban areas (12.5%) and refugee camps (12.6%) than in rural areas (10.3%). It is slightly higher among females (12.1%) than males (11.1%).

Membership in ROSCAs does not seem to be caused by inadequate penetration by formal sector institutions or lack of public knowledge about the activities of such institutions. In fact, it is more common among those who have a bank account (23.8%) than those who do not (9.5%). Limited bank lending, on the other hand, is a major factor since ROSCA membership is substantially higher among individuals who had applied for bank loans (26.9%) compared to those who had not (9.5%), and even higher among those who were denied bank loans (31.2%). This underlines the particular importance of the credit aspect of the ROSCA in the WBGS. It also implies that the reluctance of banks to lend is limiting the growth of bank deposits.

ROSCAs in the WBGS are mostly workplace-based. Their strongest presence is among office workers (27.7%), who tend to have steady jobs and are employed at relatively large work sites with opportunities for social interaction. In contrast, the presence of ROSCAs among blue collar workers is much more limited (7.6%). This is particularly the case for WBGS workers in Israel (5.4%), who have no job security and have little opportunity for social interaction with fellow WBGS workers at the workplace due to dispersion.

5. Regular Providers of Financial Services

The main providers of credit on a regular basis are moneylenders and pawnbrokers. The most common regular providers of deposit services are the moneyguards.

5.1 Moneyguards

The moneyguard is an informal financial service provider who collects deposits from customers for safekeeping purposes. The collection is usually done at the customer's place of work, often on a daily basis. The amount collected each visit tends to be very small. In Ghana, for instance, the daily collection averages about $.25. The collected deposits are kept with the moneyguard for a specific period of time, usually a month, before being returned to the depositor. In the meantime, some of the deposits are placed by the moneyguard at a commercial bank. The rest stay with the moneyguard to be used to extend loans to depositors. The moneyguard does not usually pay interest on deposits. In fact, he/she often charges a service fee, typically a day's collection, which translates into a monthly rate of 3.3%.

Some clients use the moneyguard's services because they may not want to deal with commercial banks due to religious reasons or because of an unwillingness to reveal savings to strangers. Other clients may not be able to open bank deposit accounts because of illiteracy or the small size of their deposits. Others are attracted to moneyguards because the service they provide takes place at the client's place of work, hence minimizing the clients' transaction costs.

5.2 Pawnbrokers

Pawnbroking is basically a sale-repurchase agreement.[13] The pawnbroker provides collateral-based loans. Unlike other collateral based lenders, the pawnbroker gets physical possession of the asset used as collateral or the right to use it until the loan is repaid.[14] Assets accepted as collateral at pawnshops need to be easy to appraise and to have a viable market, such as gold items, silverware, copper pots and pieces of clothing. In some countries, they also include land. If the loan is not paid, the pawnbroker is free to sell the assets, except for land, where laws in some countries prevent any sale[15] (Ghate, 1992). Once the loan is repaid, the borrower reclaims the pawned asset.

The pawnbroker is not constrained by the availability of adequate information about the borrower because of the pawnbroker's physical possession of the collateral. Hence, pawnbrokers are more likely to operate in urban areas than other informal

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13 Some borrowers have no intention of claiming the collateral and pawn the asset as a way to sell it.

14 In some pawning contracts, the pawnbroker gets only the right to use the asset during the loan period. This is particularly the case when the pawned asset is land.

15 In Indonesia, pawned land has to be returned to the borrower in ten years regardless of the payment status of the loan.

sector lenders, such as moneylenders. The pawnbroker's physical possession of the collateral also spares him/her the lengthy and costly process involved in seizing the asset once default takes place.

In some countries, however, pawnbroking is not limited to the informal sector. In Indonesia and India, pawning services are also offered by commercial banks, particularly in rural areas (Bouman and Bastiaanssen, 1992). In Indonesia and Sri Lanka, pawnshops are affiliated with banks (Adams, 1992).

Pawnbrokers are not usually required to hold a government license. However some countries, such as the Philippines, require them to register with authorities (Ghate, 1992). Loans provided by pawnshops are usually extended for one to six months.[16] The value of the loan is normally lower than the value of the pawned asset. Indian rural banks, for example, provide loans equal to 50% to 70% of the value of gold pledges (Bouman and Bastiaanssen, 1992).

5.3 Moneylenders

The moneylender usually provides loans without requiring collateral. He usually limits his lending to a small number of clients and the loans are generally small and short-term. The moneylender usually lends out of his/her own funds, which are accumulated in other markets. Deposits as a source of loans are rare and when they exist they are usually placed with the moneylender for interest-free safekeeping.[17] Most moneylenders do not require collateral. To minimize default, moneylenders limit lending to a small group of regular clients known through social contacts or other markets, or who were referred by reliable clients. Hence, moneylenders are more common in rural than in urban areas because rural areas have more channels for social interaction.[18] In some countries, such as Ghana and some parts of India, the moneylender needs a government license.

5.4 Regular Providers of Financial Services in the WBGS

Moneyguards, as defined earlier in section 4.1, do not seem to exist in the WBGS. However, the placement of funds with others is not uncommon. The 1996 MAS survey indicates that 7.1% of individuals over 18 in the WBGS place savings with other people on an interest-free basis. This practice is slightly more common in the West Bank (7.2%) than in the Gaza Strip (6.6%).

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[16] A study on pawnshops in India found that 25% of borrowers repay their loans, and hence reclaim their pawned assets, within three months; 70-75% within six months; and 5-10% in a year or more. (Bouman and Bastiaanssen, 1992).

[17] Deposits cannot be viable as a source of funds for rural moneylenders because of the seasonality of demand for rural credit. Since potential depositors, like borrowers, are mostly farmers, they are likely to make withdrawals when loans are in demand.

[18] Moneylenders who operate in urban areas tend to have much higher default rates than those in rural areas.

Pawnbroking in the WBGS is rare. Moneylending is more common. Moneylending in the WBGS is performed mainly by moneychangers. According to the MAS survey, two thirds of all those who borrowed from moneylenders in the WBGS obtained their loans from moneychangers.

Demand for money changing services in the WBGS is very strong because there are three major currencies in circulation; the new Israeli shekel, the Jordanian dinar, and the US dollar.[19] Between 1967 and 1993 when commercial banks were either non-existent or limited in number, moneychangers were the main providers of the services traditionally provided by commercial banks, in addition to changing money between currencies. They accepted deposits, extended loans and transferred funds abroad. Competition from commercial banks, which have multiplied enormously over the last four years, has cut deeply into the clientele of moneychangers, particularly in the area of deposits and the transfer of funds. Nevertheless, moneychangers have continued to play a significant role in the moneychanging market. Aside from small short-term loans, which are traditionally provided by the informal sector, moneychangers represent an important source of loans even to relatively large borrowers, including firms, because of the scarcity of physical collateral acceptable to banks.

According to the MAS survey, 1.6% of individuals over 18 obtain loans from moneychangers. Loans from moneychangers are more likely in the West Bank (2.3%) than in the Gaza Strip (0.4%).

Unlike other developing countries, the lack of accessible formal sector institutions does not seem to be an important factor influencing the demand for loans from moneychangers. In fact, borrowing from moneychangers is higher among individuals who have deposit accounts (2.9%) than those who do not (1.3%) because moneychangers often require post-dated checks as a collateral substitute. Limited lending by banks, on the other hand, is clearly an important factor influencing the demand for credit from moneychangers. Among individuals who had applied for bank loans, 3.9% did obtain credit from moneychangers, compared with 1.3% among those who had not applied for a bank loan. Of loan applicants whose requests for bank loans were rejected, 5.7% obtained credit from moneychangers.
Unlike other developing countries where moneylenders rarely operate in urban areas, borrowing from moneychangers is as common in urban as in rural areas. If we analyze the MAS survey data covering both the West Bank and Gaza Strip, we find that borrowing from moneychangers is more common in rural areas (2.1%) than urban areas (1.5%). However, if we limit our analysis to the West Bank, where most rural residents are located, we find that the demand for credit from moneychangers is actually higher in urban areas (2.7%) than in rural areas (2.1%).[20] This can be explained by the ability of moneychangers to obtain information on potential borrowers from transactions in other markets, such as check cashing services. The importance of such information is apparent in the relatively high incidence of

[19] Of the three currencies, the NIS is used mainly as a medium of exchange while the JD and the dollar are used mostly as a store of value.

The WBGS urban rate is pushed below the rural rate because of the overall low rate in the Gaza Strip. [20]

borrowing from moneychangers among WBGS workers in Israel (4.1%). This group tends to have a relatively high demand for check cashing services and moneychangers were a major provider of these services until the recent growth in the banks. Moneychangers can provide loans to this group at relatively low transaction cost as a result of information accumulated in the check cashing market.

The moneychanger's savings are his/her main source of loanable funds but deposits and equity investments from others, particularly friends and relatives, are also important sources. The interest rate paid to depositors can be higher than 2% a month, compared to less than 1% at commercial banks. Small moneychangers also obtain funds from large ones, who may have overdraft facilities at commercial banks.

If the moneychanger knows the borrower and the loan is relatively small, he/she may not require him to provide a collateral for the loan. In such cases, witnesses, usually two, represent the only evidence of the loan. If the moneychanger does not know the borrower well enough and if the loan is relatively large, the moneychanger may ask for collateral. The most common collateral is the post-dated check. The check may be personal or a third party check, usually issued by a well known employer either in the WBGS or in Israel.

The maturity of loans extended by a moneychanger is usually less than six months but loan rollover is not uncommon. The interest rate on loans provided by moneychangers can vary between 6% and 10% a month, depending on the maturity and the availability of collateral and information about the borrower.

The Palestinian National Authority (PNA) recently enacted a set of regulations that imposed severe restrictions on moneychangers (see MAS Economic Monitor, Issue 2, 1997). Under these regulations, moneychangers are not allowed to accept deposits from the public or extend credit. The ban on accepting deposits can be justified by the need to control money supply and to protect depositors. The credit ban, on the other hand, is not justifiable, given the importance of moneychangers as a source of credit and the limited credit extended by commercial banks. Based on recent experiences in developing countries, the new regulations are not expected to put an end to lending by moneychangers. However, they will probably force many of them to go underground, resulting in higher interest rates to borrowers.

6. Credit from Friends and Relatives

6.1 Main Features

Friends and relatives are an important source of loans in developing countries. In Thailand, they contribute 33% of total lending (Ghate et al., 1994). In Bangladesh, they account for 46% of all informal loans, which represents 44% of total lending. In Niger, a 1975/76 random sample survey of 400 farm households found that loans from friends and relatives accounted for 55% of informal sector credit, which in turn accounted for 45% of total credit (Douglas, 1992). In the Philippines, a field study that covered 171 randomly selected households in a village showed that 116 of them borrowed from friends and 135 from relatives (Esguerra and Meyer, 1992).

Borrowing from relatives and friends is particularly common in communities with a high variability of income, such as fishermen and farmers, and in areas vulnerable to drought. It serves as insurance against risk and smoothes consumption using temporary surplus of income. It is also important for small enterprises as a source of initial capital before establishing credit worthiness. In Ghana, a survey of small enterprises reveals that 16% of these firms rely on gifts and/or loans from friends and relatives as the primary source of capital (Aryeetey et al., 1994).

Loans from friends and relatives can take the form of cash, gifts at ceremonies, or labor provided without cash payment. It tends to be interest-free and without a fixed repayment schedule. However, it assumes reciprocity at some time in the future should the fortunes be reversed.[21]

6.2 Loans from Friends and Relatives in the WBGS

The economic environment in the WBGS is highly unpredictable. One of the main reasons for this is the frequent border closures by the Israeli authorities, leading to severe fluctuations in income, particularly among those who work in Israel and who account for a significant share of the labor force. In such an environment, friends and relatives represent an important source of credit. They also facilitate access to bank credit by serving as guarantors.

The role of friends and relatives in facilitating bank credit is apparent in the widespread use of bank deposits as collateral in the WBGS banking system. Data collected by MAS in 1996 indicates that bank deposits were used in more than 30% of the loans extended by WBGS commercial banks. Sometimes these deposits are used to back loans for the depositors themselves to avoid penalties for early withdrawals from time deposits or to take advantage of expected fluctuations in foreign exchange rates. However, discussions with bank officials indicate that the most frequent use of

[21] Reciprocity is not calculated. It is inferred.

bank deposits is to guarantee loans for others. Loans from friends and relatives are almost always interest-free and have no fixed repayment schedule.

The importance of friends and relatives as a source of credit was supported by the MAS survey. According to this survey, 26.9% of WBGS individuals over 18 borrow from friends and relatives. This is almost as common in the West Bank (26.4%) as in the Gaza Strip (27.8%).

Borrowing from friends and relatives tends to be more common among groups with relatively high income variability. Generally, it is higher among blue collar workers (30.4%) than clerical workers (28.6%). It is particularly high among WBGS workers in Israel, whose income is erratic due to constant border closures (32.9%).

Credit from friends and relatives varies positively with the strength of social ties, which is to be expected because these ties increase the probability of reciprocity and loan repayment. The strength of traditional ties, as measured by attending social functions such as weddings, increases the likelihood of borrowing from friends and relatives in both urban and rural areas. According to the MAS survey, 27.2% of urban residents who participated in at least one traditional social function in the three months preceding the survey borrowed from friends and relatives, compared with 21.4% of those who did not participate. Comparable figures for rural residents are 27% and 22% respectively. The strength of non-traditional social ties, as measured by participation in club activities and political events, increases the likelihood of borrowing from friends and relatives in urban but not in rural areas. Of urban residents who participated in at least one non-traditional social function in the three months preceding the MAS survey, 28.5% borrowed from friends and relatives, compared to 22.7% of those who did not participate. Comparable figures for rural residents are 26% and 25.9%.

Contact with the formal financial sector does not seem to be a significant factor in determining the likelihood of taking a loan from friends or relatives. 25.8% of individuals with bank accounts indicated that they received loans from friends and relatives, compared to 27.2% of those without bank accounts. In contrast, the availability of bank credit is clearly an important factor in the demand for credit from friends and relatives. Of those who have applied for bank loans, 40% obtained loans from friends and relatives, compared with 25% of those who have not applied for bank loans. Among bank loan applicants whose request for loans were denied, borrowing from friends and relatives is even more common (43.6%)

7. Lending NGOs

7.1 Role in Developing Countries

NGOs represent an important source of credit in many developing countries. Lending NGOs provide credit to groups that have little or no access to the formal financial sector. Aside from serving the immediate credit needs of these groups, lending NGOs also help their members build a credit history, which increases the likelihood of getting access to formal credit.

A lending NGO can help a targeted group either by serving as a vehicle for credit subsidies or by providing it with access to unsubsidized credit. However, recent experience in developing countries argues against providing subsidized and unsubsidized credit by the same NGO.

A lending NGO that aims to provide unsubsidized credit may initially be heavily subsidized by government authorities or foreign donors. It may also receive some help from volunteers to cover transaction costs. Such subsidies are sometimes essential for covering the NGO’s start-up costs, such as the costs of equipment and training. However, the NGO cannot count on receiving subsidies indefinitely. Hence, if the NGO is to provide credit to targeted groups on an ongoing basis, it has to become self-supporting. This requires it to be managed in a financially sound manner, which entails charging market interest rates. The lending NGO then becomes a vehicle for providing access to credit, the lack of which is often the main constraint to income-generating investment by targeted groups, and not credit subsidies.

Some NGOs lend directly. Other NGOs facilitate borrowing from the formal sector by providing borrowers with guarantees. Others serve as a conduit to formal sector lenders by helping to screen loan applicants, supervising the use of funds by borrowers, and ensuring loan repayment.

Like the informal sector, successful lending NGOs do not usually require borrowers to provide physical collateral, relying instead on collateral substitutes. Some NGOs extend loans as part of a package of services that include technical assistance and marketing help. The risk of losing these services increases the likelihood of loan repayment by borrowers, providing the lending NGO with a valuable collateral substitute. Other NGOs use the solidarity lending mechanism as a collateral substitute. Under such a mechanism, the borrower selection is left to the group, which in turn assumes collective responsibility for loan repayment. In other words, if one member fails to pay, his debt is transferred to the borrowers as a group. This puts enormous peer pressure on borrowers to avoid default and provides them with a strong incentive to screen out high risk individuals. The solidarity lending mechanism was pioneered by the Grameen Bank in Bangladesh in 1976 and has been used effectively in recent years to extend small short-term loans in many developing countries.

7.2 Role in the WBGS

NGOs represented a major source of loans in the WBGS in the 1980s and early 1990s. In 1993, 14 such NGOs operated in the WBGS. The total lending by these NGOs, which were funded by foreign donors, was $16.2 million in 1993, compared to $17 million in total bank lending. Some lending NGOs that operated in this period charged no interest on their loans, while others charged interest rates that were substantially below prevailing market rates. Their loan default ratios were very high, exceeding 50% at some NGOs. Despite the high default rates, lending NGOs refrained from taking borrowers to court or foreclosing on their properties to avoid forced sales to Israeli settlers and their supporters.

The banking system has expanded substantially over the last 4 years. By June 1995, the number of bank branches was 80, compared to 13 in 1993. The resulting increase in bank lending has been concentrated in the low risk segment of the market, forcing lending NGOs to cater to riskier borrowers who do not have collateral acceptable to commercial banks. In addition, it has become increasingly difficult for NGOs to raise funds from donors because of financial competition from PNA institutions. Consequently, the relative importance of NGOs in the WBGS credit market has decreased substantially over the last four years.

At the end of 1996, there were 22 lending NGOs in the WBGS (see Statistical Annex). Some of these NGOs, such as Jenin Charitable Society, are local charities that provide interest free loans to a small number of people. Others, such as the PDF and UNRWA, offer national lending programs that provide loans for a wide range of economic activities. Between them, NGOs provided loans to 10,420 borrowers in 1996. The total value of these loans was $16.4 million, which represents 3.9% of total bank lending.

The rest of this section discusses the main adjustments made by lending NGOs in the last four years in response to changes in their operating environment. It then examines in some detail the operations of three major lending NGOs, including the adjustments they have made in the last four years.

Before 1993, most NGO loans were backed by third party guarantees. While this practice is still the norm at most NGOs, in recent years some have instituted new mechanisms to minimize default. To reduce the default rate without requiring physical collateral, Save the Children launched a new lending program in 1995 based on group solidarity as a collateral substitute, a mechanism used effectively in many developing countries. This lending program replaced a more traditional program that provided loans backed by third party guarantees. The ADCC (The Arab Development and Credit Company), TDC (The Arab Technical and Development Corporation) and EDG (The Economic Development Group) merged in 1996 to form the Palestine Development Fund (PDF). Unlike its founding organizations which extended loans backed almost exclusively by third party guarantees, the PDF relies increasingly on physical collateral. UNRWA dismantled a loan guarantee program, which relied heavily on third party guarantees and replaced it with two new lending programs, namely, The Solidarity Group Lending Program (SGLP), and The Microenterprise Lending Program (MLP). The MLP provides loans backed by post-dated checks. To encourage timely loan repayment, it starts with a relatively low lending limit that is increased gradually, depending on the borrower's repayment pattern. The SGLP uses group solidarity as a collateral substitute.

Lending NGOs have become more aggressive in their enforcement of loan contracts due to the cooperation of PNA law enforcement authorities. In some cases, the mere threat of legal action results in loan repayment.

Table 1: Interest Rates and Default Rates at Selected NGOs

NGO	Default Rate (%)	Loan Maturity (Years)	Rate of Interest (%)
Arab Center for Agricultural Development	15	1-3	9 a year (in JD)
Care International	-	Up to 3	12 a year (in NIS)
Caritas	-	2	6 a year (in $)
International Christian Committees	20	1-3	zero
Jenin Charitable Society	50	1-3	zero
Palestinian Development Fund	25	1-5	7-8 a year (in JD)
Save the Children	Under 1	.5	2 a month (in JD)
UNRWA			
The Micro Enterprise Credit Program	4	1-3	2.2 a month (in NIS)
The Small Scale Enterprise Program	-	under 1	10 a year (in $)
Gaza Strip	5.2	under 1	10 a year (in $)
West Bank	0.26	under 1	10 a year (in $)
The Solidarity Group lending Program	under 1	.5	2.2 a month (in NIS)

By 1997, the default rate was down sharply. For example, the group solidarity lending programs offered by Save the Children and UNRWA had a default rate below 1% in 1997. Default rates at other NGO lending programs are not as low, but are substantially lower than the prevailing levels before 1994, which were in excess of 50% (see Table 1).

Most lending NGOs have increased their interest rates over the last four years. Some, such as the group solidarity lending programs run by UNRWA and Save the Children, are already charging interest rates high enough to cover their operating expenses. Others, however, charge below market rate and one NGO does not charge interest at all (see Table 1).

Obviously, donors cannot be expected to subsidize lending NGOs indefinitely. Therefore, if these NGOs are to provide credit to targeted groups on an ongoing basis, they need to pursue policies that make them sustainable and charge interest rates that reflect the lending costs. Lending NGOs should also take advantage of collateral substitutes to reduce their default rates. In addition to the successful group solidarity mechanism, NGOs can bundle their loans with other services. An NGO that provides agricultural extension or technical services, for instance, can use the information thereby acquired to screen loan applicants. In addition, the risk of losing these services can serve as a deterrent for the borrower against loan default.

7.3 The Palestinian Development Fund

The Palestinian Development Fund was established through a 1996 merger of three lending NGOs which operated in the WBGS during the 1980s, namely, the ADCC (The Arab Development and Credit Company), TDC (The Arab Technical and Development Corporation) and EDG (The Economic Development Group).[22] The areas to which these organizations extended credit varied. The EDG loaned to enterprises in all economic sectors, the ADCC's loans were targeted towards the agricultural sector and the TDC specialized in lending to large scale enterprises in the industrial, tourist and service sectors. The PDF currently extends credit to all sectors of the economy.

About 80% of PDF funding comes from the European Union. Other donors to the PDF and member organizations include the Welfare Association, Spain, Italy, Canada, Australia and Japan. Although there was a noticeable increase in total funding to the PDF and its founding organizations after 1993, most of these funds were part of loan commitments made earlier. In fact, the value of new fund commitments has decreased in the last four years.

Table 2: Total Lending by PDF and Its member Organizations, 1988 –1997

Year	Number of outstanding loans	Value of outstanding loans ($)
1987	11	31,000
1988	53	147,500
1989	170	1,393,000
1990	181	1,279,000
1991	250	1,620,500
1992	130	1,364,500
1993	297	4,614,500
1994	142	5,518,500
1995	166	7,149,930
1996	76	3,614,000
1997	132	7,719,000
Total	**1,608**	**34,451,430**

In October 1997, the PDF had 40 employees and 1,608 outstanding loans, with a total value of $34,451,430 (see Table 2). This translates into a 40.2 loan-employee ratio. Of the total number of outstanding loans, 138 have been issued since the establishment of the PDF in August 1996. The rest of the outstanding loans were accumulated by the three founding organizations.

PDF and member organization operating expenses for 1996 were $1,320,000. Total interest earnings for the same period were $1,207,000. This means interest income covered 91% of operating expenses.

[22] The three organizations are still operating under their individual names in the Jerusalem area.

Before 1993, loan applicants to PDF founding organizations were only required to provide two guarantors. Since then, applicants have been increasingly required to provide physical collateral, such as registered land and equipment registered at the Ministry of Labor. Borrowers are also required to provide post-dated checks and IOUs. The PDF and member organizations have also been more aggressive in loan collection in recent years. As a result, there was a significant drop in default rates. In the 1980s and early 1990s, the average default rate was about 50%. By 1997, it was down to 25%.

Table 3:PDF and Market Interest Rates in 1997

Loan Maturity*	Interest Rates PDF (%)	Interest Rate Market (%)
Less than one year	7.5	9
1-3 years	7	9
3-4 years	7.5	9
4-5 years	8	9

* Loans for less than one year are extended for working capital only, while those with maturity of more than one year are extended for investment capital.

The interest rates charged by the PDF founding organizations increased significantly in recent years. By 1997, interest rates reached 7-8% per annum, compared to 3% in the 1980s and early 1990s (see Table 3). In addition, borrowers are now required to pay one percent annually as a service fee. However, PDF interest rates are still below market rates.

7.4 UNRWA

The United Nations Relief and Works Agency for Palestine Refugees in the Near East (UNRWA) provides education, health, relief and social services to Palestinian refugees in the Middle East. Starting in 1991, UNRWA provided JD denominated loans for business development in the West Bank under the Bank Guarantee Program (BGP). In the same year, it began offering dollar denominated loans to small enterprises in the Gaza Strip under the Small Scale Enterprise Program (SSEP). The BGP was terminated in 1994 because of high default rates. The SSEP was extended in 1996 to the West Bank. In addition to the SSEP, UNRWA presently offer two other lending programs, namely the Micro Enterprise Credit Program (MECP) and the Solidarity Group Lending Program (SGLP). In designing the two new programs, UNRWA included features aimed at minimizing default. At the end of 1997, UNRWA had issued 10,226 loans with a total value of $20.4 million.

The Small-Scale Enterprise Program was launched in June 1991 in the Gaza Strip, and in February 1996 in the West Bank. The program provides capital investment loans in US dollars for existing as well as new enterprises. Funded projects are in the fields of medical services, domestic services, printing and publishing, automobile repair, agricultural services, fishing, wood manufacturing, and textiles. The average loan size in 1997 was $10,000. The default rate has been about 5.2% in the Gaza Strip and under 1% in the West Bank. The annual interest rate is 10%, with a service fee of 1% paid to the bank to administer the loan account.

Loans are backed by third party guarantees. In addition, the borrower has to invest in the project 10-50% of the value of the project. Program officers visit the borrower at least once a month and provide business advice. Repayment data is reviewed weekly. If the client falls in arrears, three warning letters are sent to both the client and the guarantors before the guarantor's salaries are frozen.

At the end of 1997, the program had 391 outstanding loans in the Gaza Strip and 157 in the West Bank. The total values of these loans was $4 and $1.7 million respectively.

The Solidarity Group Lending Program was launched in May 1994. It provides small NIS denominated working capital loans to women microvendors and microenterprise owners in the Gaza Strip. Loans are extended through solidarity groups. Groups are formed voluntarily. Group members determine the amount of the loan needed by each member and the total sum is considered as a collective loan for which the group as a whole is responsible. No member is eligible to borrow an additional amount unless all members have paid off their previous loans. Group membership ranges between 4 and 9. The program offers training in group formation and credit management. Once selected, all members are required to attend training sessions before taking their loans. A borrower is eligible for a larger loan each time she successfully repays her previous loan. First-time borrowers receive loans of up to NIS 1,000 to be repaid within six months and there is no grace period. Repayment begins one month after the loan is awarded. A borrower who is more than seven days late in making payments is considered to be in arrears and subject to a late payment fee.

As of the end of 1997, the program provided loans to 6,380 women organized in 1,100 solidarity groups. The total value of these loans is $4.46 million with a loan recovery rate of almost 100%. The interest rate is 2.2% per month.

The Micro Enterprise Credit Program began in February 1996. It provides NIS denominated working capital loans to existing enterprises. First time borrowers can take a loan of up to NIS 2,000 to be repaid over four months or NIS 3,000 to be repaid over six months with no grace period. After the repayment of the loan, the borrower can double the size of the loan.

At the end of 1997, the program had 1,213 outstanding loans, with a total value of about $1 million. Clients are charged a monthly interest rate of 2.2%. Loans are backed by post-dated checks. Borrowers who are more than seven days in arrears have to pay 1% as a late payment fee and the default rate is about 4%.

7.5 Save the Children

Save the Children has been providing a variety of services in the WBGS since 1978. These services include water and sanitation projects, agricultural access roads, and kindergartens. The projects are generally implemented in partnership with the community that benefits from them. Save the Children usually contributes 50% of the costs of the project while the community contributes the rest.

The first lending program offered by Save the Children was set up in 1992. The program offered three year loans backed by third party guarantees. Interest rates on these loans were below market levels. The program was terminated in 1996 because of the high default rate, which averaged about 20%.

In 1995, Save the Children launched a group solidarity lending program (GSLP). Lending by this program is limited to women organized in solidarity groups of at least 10 members. Members of the group bear responsibility for loan repayment by every other member. The group must hold four preparatory meetings before being certified by Save the Children as a solidarity group.

The GSLP began in Nablus and was later extended to other communities in the WBGS. By the end of 1997, it had more than 5,500 borrowers and plans anticipate 20,000 borrowers by 1999. The program is limited to women and does not extend loans to new enterprises, only existing ones.

The loans provided by the GSLP are extended for six months and repaid in bi-weekly payments. The loan starts at JD 200 per member. If the group repays its loan, the loan size is increased gradually until it reaches a maximum limit of JD 1000. At the end of November 1997, the value of the program's outstanding loans was $850,000.

The GSLP is presently supported by donors but aims to become self-supporting. It charges a flat interest rate of 22% plus $3 loan fee. Interest income and fees currently cover 60% to 70% of the program's operating costs. The program's default rate is less than 1%.

8. Summary and Policy Implications

Despite the recent expansion of the WBGS banking system, financial intermediation in the WBGS is still very limited. While the sharp growth in bank branches has resulted in a rise of bank deposits by more than 600% in the period 1993-1997, bank lending expanded at a much lower rate, resulting in a loan-deposit ratio of only 25%. In this environment, informal finance has played an important role. Semi-formal finance, represented by lending NGOs, has also been a significant source of loans. Nevertheless, the roles of both informal and lending NGOs in the WBGS could still be enhanced.

The main informal sector mechanism for the placement of savings with friends and relatives are the ROSCAs. Informal sector mechanisms include borrowing from moneychangers, borrowing from friends and relatives, and the ROSCA, which has both a credit and a saving function. According to the MAS survey, 7.1% of WBGS individuals over 18 keep surplus funds with moneyguards, an informal sector arrangement that does not pay interest. In contrast, 15% have bank deposit accounts. The relative importance of the informal sector in the credit market is even higher. Trade finance and loans from friends and relatives are common and lending by moneychangers is a major source of loans for both households and firms. Of the individuals covered by the 1996 MAS survey, only 7.1% obtained bank loans. In comparison, 27% borrowed from friends and 1.6% obtained credit from moneychangers. Finally, ROSCAs are widespread in the WBGS, attracting 11.6% of individuals over 18, according to the MAS survey.

Of the informal financial mechanisms in operation in the WBGS, ROSCAs and moneyguards mobilize deposits without subjecting the public to undue risk. Hence, their operations do not require government regulations. Providers of trade finance do not appear to accept deposits from the public, which makes it unnecessary to subject their credit operations to government regulation. In contrast, a case can be made for banning moneychangers from accepting deposits from the public because of their involvement in high risk financial activities without being subject to regulations aimed at protecting depositors and stabilizing the money supply. However, once moneychangers cease to accept deposits, they should be left to continue their other activities unfettered. Hence, new regulations by the Palestine Monetary Authority which aim to keep moneychangers out of the credit market cannot be justified. If the authorities wish to influence moneychangers and other informal credit providers, including the interest rates charged by them, they can do so by pursuing policies which would increase competition in the informal sector through increased bank lending.[23] Another area where government action could be helpful is in the practice of using post-dated checks. These are widely used by the informal sector as a collateral substitute and without doubt increase the availability of informal credit at a time when bank lending is limited. However, this practice represents a potential source of instability for the WBGS banking system. Ultimately, when bank lending increases

[23] Possible policies that can increase bank lending in the present political and economic environment in the WBGS are discussed in Hamed, 1996.

significantly enough to reduce reliance on the informal sector as a source of credit, post-dated checks may have to be banned. In the meantime, a law to penalize the writing of bad checks could help to reduce the risk these checks pose for the stability of the banking system.

The relative importance of NGOs in the WBGS financial system decreased over the last four years due to the expansion of the domestic banking system and competition from the PNA for donor funds. Nevertheless, NGOs still represent an important source of credit in the WBGS.

Lending NGOs have undergone major structural changes in the last four years to adjust to changes in their operating environment. To reduce reliance on donors, most NGOs have raised their interest rates. Some of them, such as Save the Children, are already covering a significant share of their operating expenses through their interest income. Others still charge below market interest rates or no interest at all, as is the case with the Palestinian Agricultural Relief Committees. To minimize default, some NGOs began to utilize the group solidarity lending program as a collateral substitute. However, lending by most NGOs is still backed mainly by third party guarantees.

More adjustments need to be made if lending NGOs are to reduce their dependence on donor funding, which cannot be expected to continue indefinitely. The donors can be helpful in encouraging lending NGOs to become fiscally sound by gradually phasing out support for operating costs and limiting their funding mostly to fixed set-up costs. They can also help to reduce default rates by encouraging more NGOs to utilize the group solidarity lending mechanism and by promoting lending programs offered by NGOs that provide other services to borrowers, provided they use these services effectively as a collateral substitute.

The informal financial sector, as well as lending NGOs, can be used more effectively to channel formal sector funds to borrowers. Currently, WBGS commercial banks do not take advantage of the informal sector to reach potential borrowers that do not qualify for their traditional loans. Nevertheless, some of these borrowers get indirect access to bank credit through trade finance and moneychangers. Based on evidence from developing countries, commercial banks can broaden their borrower base without subjecting themselves to undue risk by using the informal sector in screening loan applications and collecting loan repayments.

In the WBGS environment, ROSCAs, which have been used successfully as outlets for bank lending in some developing countries, represent a promising prospect. To start with, commercial bank can extend a short-term loan to a ROSCA member by making an arrangement for a direct transfer of the member’s kitty to the bank. The ROSCA can also facilitate bank lending by lowering the transaction costs of bank lending. Such costs can be reduced by enabling the bank to take advantage of accumulated information on members’ saving patterns and default risk. Further reduction in transaction costs can be achieved by making the ROSCA collect loan payments. Finally, ROSCAs can be used as a basis for group solidarity lending.

Commercial banks in the WBGS can also use NGOs to channel funds to borrowers. Like ROSCAs, NGOs can reduce transaction costs, and hence facilitate bank lending by screening loan applicants and collecting loan payments. Financially sound NGOs can also increase bank lending by guaranteeing bank loans or obtaining loans from banks to be lent on to targeted groups.

Statistical Annex
Lending NGO's by Number of Borrowers and Loan Size

		Number of Borrowers			Loans in US $		
Program	**Year of Establishment**	**1944**	**1995**	**1996**	**1994**	**1995**	**1996**
Engineer's Professional Association	1980's	n.a.	n.a.	n.a	n.a.	n.a.	282,127.23
Al-Zouhour Kindergarten Association	-	n.a.	n.a.	10	n.a.	n.a.	28,212.72
Silwan Charitable Society	-	n.a.	n.a.	10	n.a.	n.a.	7,053.18
Ex-prisoner Rehabilitation	-	n.a.	n.a.	813	n.a.	n.a.	2,032,500
El-ber Forum	1962	n.a.	n.a.	24	n.a.	n.a.	39,930
Care International	12/1995	n.a.	n.a.	169	n.a.	n.a.	209,000
The Arab Society for the Blind	-	n.a.	n.a.	10	n.a.	n.a.	4,562.04
Saraya Center for Social Works	-	10	10	10	12,000	12,000	12,000
International Christian Committees	1967	136	53	75	193,660	95,950	121,000
Oxfam -Quebec	1996	0	0	0	0	0	0
Jenin Charitable Society	-	17	5	14	5,339	1,748	14,106.36
Palestinian Housing Council	-	n.a.	1,996	n.a.	n.a	30,000,000	n.a.
UNRWA- Solidarity Group Lending Program	1994	178	584	1987	58,933	278,350	1,261,149
UNRWA- Small Scale Enterprise Program	1991	54	135	205	1,611,725	2,795,550	3,272,865
UNRWA - Micro Enterprise Credit Program	1996	-	-	1,040	-	-	1,202,795
Agricultural Relief Committee	1993	n.a.	n.a.	n.a.	68,000	74,000	88,000
Caritas	1967	150	150	130	400,000	400,000	400,000
Co-Operation for Development (CD)	1988	0	0	0	0	0	0
American Near East Refuges Aid	1968	591	132	210	1,500,000	2,100,000	2,800,000
Arab Center For Agricultural Development	1988	32	32	68	201,342	215,300	398,400
Save the Children	1978	90	50	5,500	320,000	175,000	800,000
Women's Training Program (YMCA)	8/1993	4	4	4	4,000	4,000	4,000
Civil Society Program (YMCA)	8/1993	10	18	40	50,000	60,000	100,000
Mental and Vocational Rehabilitation Program (YMCA)	8/1993	17	20	24	34,187	40,220	48,264
Agricultural Crops Marketing Cooperative	1984	0	0	0	0	0	0

Palestinian Development Fund	1997	186	185	77	6,987,000	8,150,000	3,664,000

n.a. : not available

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