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# THE DEMAND FOR INFORMAL FINANCE IN THE CONTEXT OF URBAN AFRICAN MARKETS: THE IMPORTANCE OF SOCIAL RELATIONS

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Abstract

This paper provides an empirical analysis of the demand for financial services by micro-entrepreneurs operating in urban African markets. It particularly seeks to identify the motivations behind the use of the so-called informal financial practices in an environment where formal financial markets are active. The evidence provided in this paper is in sharp contradiction with the idea that that participation to informal finance is solely triggered by the lack of access to formal financial market. Using a first-hand dataset collected in three markets located in Ouagadougou, the capital city of Burkina Faso (West Africa), this paper shows that the use of some financial devices is, to some extent, dependent on motivations that are not financial in nature such as the need to create or enhance social relations.

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## 1. Introduction

The economic literature, particularly in the field of development economics, tends to associate participation to informal financial markets with the lack or weak access to formal financial markets (Hoff and Stiglitz, 1993). This long lasting idea has its roots in two main theoretical arguments. The first argument draws from the financial repression theory (McKinnon, 1973, 1976 and Shaw, 1973) which views informal financial markets as a result of State intervention in financial markets through a set of regulations, laws, as well as non-market restrictions.[1] Financial repression policies such as interest rate ceilings, high liquidity ratio requirements, high bank reserve requirements, capital controls, restrictions on market entry into the financial sector, credits controls as well as and nationalization of banks (government ownership or domination of banks). All these policies result in an inefficient allocation of capital as they discourage savings while reducing the supply of credit by banks. Hence, it prevents some people from accessing credit, even though without these restrictions, they would qualify for obtaining bank loans. The resulting unsatisfied demand for loans is absorbed by the unorganized informal money market which acts as a residual market such as to allow financial markets to clear (Van Wijnbergen, 1983). Ultimately, financial repression affects adversely economic growth due to its inefficient resources allocation.

The second theoretical argument draws from the theory of information asymmetries developed by Stiglitz and Weis (1981). While the financial repression theory insists on the *exogenous* origin of credit restrictions and puts the blame on State interventions, Stiglitz and Weiss point the finger to *endogenous* markets failures. In their influential paper, Stiglitz and Weiss (1981) show how – in a context of limited liability[2]- information asymmetries between the borrower and the lender can lead to credit rationing. Their argument can be briefly put as follows: when banks have limited information on their borrowers, they are not able to distinguish between safe and risky borrowers. Hence, they have to rely heavily on collaterals and those without sufficient collaterals are excluded from the credit market or *quantity rationed.*

[1] The rationale of financial repression lies in the fact that, by controlling the financial sector, the Government has access to cheap resources. Indeed, financial repression constitutes an implicit fiscal policy as a system of high liquidity ratios (or high bank reserves), the increases the base money and thereby, seigniorage revenue. In the same way, interest rate ceiling help reducing the fiscal burden for highly indebted Government while direct control of credit allocation allows Government to ensure stable provision of capital to strategic economic sectors.
[2] Limited liability implies that the borrower bears no responsibility to pay out of his pocket in case the returns generated by his project are not enough to meet his debt obligations.

Finally, both the financial repression and the information asymmetry arguments focus exclusively on the behavior of the *suppliers* of financial services in the presence of either Government restrictions or markets imperfections. The demand for informal finance is not dealt with directly. Instead, it is seen as a shadow of the unsatisfied demand in the formal market. Nevertheless, these two arguments have had significant influence on the subsequent analysis of the so-called informal financial practices. This is notably the case for studies dedicated to the rationale of participation to informal financial associations known as Roscas where it is the implicitly or explicitly assumed that those participating to Roscas have no access to other saving techniques (Besley, Coate and Loury, 1993, Anderson and Baland, 2002, Gugerty, 2006).[3]

However, the view that those participating to informal finance are necessarily quantity rationed does not resist empirical evidence as recent field studies have revealed that some individuals having access to formal markets continue to be active in informal markets. Such cases have been identified, among others, in Zimbabwe where 77% of market traders who participate in Rosca had also a bank account as reported by Chamlee-Wright (2002). A more recent study carried in Bangladesh, India, and South Africa, Collins, Morduch, Rutherford and Ruthven (2009) revealed that low Income people use a mixture of informal and formal financial devices in order to manage their daily budget. The objective of this paper consists in a meticulous check up of the motivations behind the use of financial practices in an environment where both informal and formal financial practices coexist so as to shed light on the rationale of such coexistence.

The remaining of this paper is organized as follows; the next section attempts to outline a framework for analyzing the demand of informal finance and discusses the usefulness of the concept of reciprocity for this framework. The third section provides a discussion of the empirical strategy and provides some descriptive statistics while the last section concludes.

## 2. A framework for analyzing the demand for informal financial services

As mentioned above, economic models analyzing the demand of informal finance invariably make the assumption that participation to informal financial markets is mainly triggered by "the lack or weak access to formal financial markets" or in other words by "financial exclusion". Such an assumption excludes, a priori, the possibility of a deliberate decision to join the so-called

[3] Roscas are informal associations whereby individuals agree to meet on a regular basis and convene to contribute a given sum of money to a common pot. This pot is allocated to one of them each time they meet and whoever receives the pot is excluded from receiving it again before each member has had his turn (Anderson & Baland, 2002).

informal financial practices. However; some authors challenged the financial exclusion assumption by suggesting that informal finance can sometimes be the optimal choice even for individuals with access to formal markets. Some of the explanations put forward by these authors include the fact that *transactions costs* are, sometimes, lower in informal financial markets than in formal markets (Kochar, 1992, Chung, 1992, Barham et al. 1996 and Mushinski, 1999). Another explanation is that the contracts offered by informal finance are, in some instances, *less risky* than those in formal markets (Boucher & Guirkinger, 2004, Boucher, Carter, & Guirkinger, 2005, Guirkinger, 2006). The models developed by these do not make the financial exclusion assumption and show how factors such as transactions costs and risk-sharing rules affect the demand for informal loans.

This paper endeavors to go a step further by considering a broader range of motives behind the use of financial practice. An important focus is put on motivations that are not necessarily financial in nature such as motives related to social relations. Indeed, some scholars such as Guérin et al (2010) argue that "*social motives play a non-negligible role in explaining the persistence of informal financial practices*". From a theoretical perspective, the effect of social relations on economic outcomes can be traced back to the concepts of "*social embeddedness*" and "*reciprocity*" that were first coined by Polanyi (1944) in his famous book "the Great transformation".[4] While the concept of embeddedness refers to "*the extent to which economic action is linked to or depends on action or institutions which are non-economic in content, goals or processes*" (Granovetter, 2005), the concept of reciprocity could be defined as a mechanism of gift exchange with the objective of *enhancing their social relations*. The concept of reciprocity is briefly discussed in the next section

## i. The reciprocity principle: a fruitful concept

In the Great Transformation and in his subsequent publications, Polanyi did not consider the price-making market as the sole and natural *form of economic integration*.[5] He identified two other forms of economic integration or institutionalized processes of production and exchange which are (1) the *Reciprocity* and (2) the *Redistribution* systems of economic integration.[6]

[4] The Great Transformation is basically a historical analysis of the transformation through which went the western economies in the late eighteenth and early nineteenth centuries. It is the history of the emergence, the blossoming and the demise of the self regulating market (Anne Mayhew, 2000).

[5] The "*form of economic integration*" refers the entire process/system that allows the occurrence of human interactions (exchanges) and gives to these interactions the required stability to sustain.

[6] Polanyi identified a fourth form of economic integration which is namely the household administration whereby the production takes place within the household and for the household. However, later on he considered this form of economic integration as a particular case of redistribution that is organized at the household level.

Under the market principle, the production and the coordination of exchanges are based on a *price mechanism* whereby prices are freely determined by market forces. In such a mechanism the price is expected to reflect the value of the good or the service being exchanged. It is the rule of *cost equivalence*.[7] The logic behind market exchanges is that of *anonymity* as individuals are assumed to be identical in all respects. Hence, the interdependence between individuals on the market is of a *mechanical* nature. Under the redistribution principle, the exchanges rely on a mechanism which requires the existence of both a *Central authority* and a set of rules or laws allowing the central authority to collect and redistribute resources. The logic at work is that of *centricity* or *protection* and the interdependence between individuals is of a *legal* nature.

Contrary to the market and redistribution principles, the mechanism underlying the principle of reciprocity is based on *symmetric social relations of kin and/or community*. The logic at work is that of *symmetry* while the interdependence between individuals is constructed on a *voluntary* basis (Servet, 2007). Concretely, a system of economic exchanges based on a mechanism of reciprocity displays three main features as described below.

First, the reciprocity principle entails at least two of the three stages of the famous Potlatch triadic cycle – *give*, *receive* and *give back* – *as* explained by Mauss (1925) in the *gift paradigm*. This cycle is based on symmetrical relations of *gift* and *counter gift*. However, while the rule of cost equivalence prevails on the market, the gifts exchanged under the reciprocity principle may happen to be of totally different values. In some instances, the counter gift – in the form of a foreseeable physical benefit for the gift giver – may even not be expected in which case the gift process reduces to two stages: giving and receiving.[8] Second, under the reciprocity principle there is no price mechanism based on the cost equivalence rule as this is the case for the market principle. This second feature follows directly from the previous since the counter gift does not need to reflect the value of the initial gift. Third, under the reciprocity mechanism, exchanges are not only intended to allow the transfer of goods and services but also to create or enhance the social ties between the stakeholders. It may even be the case that a gift exchange under the reciprocity principle is solely intended to create or consolidate social relations. As highlighted by

[7] The cost-equivalence rule stems from the fact that on competitive markets the cost of production equals the price of output, provided that a rate of return on investment is included in cost. As Bell (1991) puts it: "*in neoclassical ethics, prices that exceed cost are unfair to consumers and imply the exploitation of monopolistic advantage, while prices that are below cost are unfair and may represent unfair competition* – in the form of a – *dumping*"

[8] Note that the forms taken by gifts can range from material objects such as physical goods or services to immaterial objects such as social recognition.

Servet (2007) reciprocity mechanisms are embedded in broad relationship schemes where the stakeholders convene implicitly or explicitly to take part in a relationship of complementarity and voluntary interdependence. Note that it does not matter whether the need to create or enhance social relations is driven by the search of personal benefit, by kindness or even imposed by some social norms.[9]

### ii. Reciprocity and the demand for informal finance

Considering that some informal financial practices are highly embedded in a reciprocity mechanism and as such have a high potential of generating or enhancing social relations, it is quite important to account for the effect of such social relations while analyzing the determinants of the financial behavior of individuals involved in those practices. This is the case for practices such as Roscas and loans between friends which are characterized by their extreme reliance on social relations. These financial practices take place between friends and acquaintances. They can also occur between friends or acquaintances of friends as well. Indeed, this chain of social relationships allows the blossoming and the rooting of the confidence between individuals who decide to get into financial transactions. Moreover, such practices constitute place where new social relations are forged and existing networks expanded or consolidated.

At the end, one can identify two channels through which social relations affect the decision to join a financial practice embedded in a reciprocity mechanism. On the one hand, the decision to join a financial practice that is embedded in a reciprocity mechanism can be motivated by the opportunity offered by such a practice for creating new or consolidating existing social relations. On the other hand, the fact that existing social relations act as a source of confidence between individuals taking part to a financial transaction cannot be underplayed. In fact, participation to practices such as Roscas is likely to depend on the social proximity of the members. As mentioned earlier, social proximity is a source of information on the other members and, as such, it acts as a *social collateral* ensuring the success of the financial transaction (Besley and Coate, 1995). However, both channels often act simultaneously making it rather difficult to disentangle them.

[9] Polanyi and his disciples were criticized for allegedly assuming the forms of economic integration to be founded on different human motives whereby reciprocity would be correlated with kindness while the market would be driven by greed and rational calculation. However, this critic was actually taken into account by Polanyi who was "careful to note that the range of human motives varies little across systems…" (Mayhew, 1994)

Hence the following conjuncture:

> *Conjuncture: Social relations play an important role in the decision to enroll in informal financial practices that are obviously embedded in a reciprocity mechanism.*

*Corollary: One of the implications of this conjuncture is that even in the absence of any sort of financial rationing (exclusion), an individual may still find it optimal to resort informal financial instruments.*

### iii. Important remarks about social relations

Before considering some empirical results, let us mention two important remarks about social relations. On the one hand, the definition of the concept of social relations used in this paper follows from Grossetti (2009) who identified three minimal conditions for a social relation to be valid. First, individuals into a social relationship are expected to know each other i.e. to *have information about each other* and are expected to adjust their behavior accordingly. Second, they must accept a *mutual commitment* to enter into co-operative (non-conflictual) interactions. Third, their interactions lead *to specific forms of trust*. These relations exclude occasional and transient business interactions.

On the other hand, it is important to note that the commitment of the stakeholders to a social relation is reflected through the *obligations* and *rights* generated by such a social relation. Indeed, social relations can be analyzed as a set of rights and obligations individuals have vis-à-vis their friends and acquaintances. Therefore, the desire to join a financial practice embedded in a mechanism of reciprocity will depend on the perceived importance or weight of rights and/or obligations generated by social relations arising from such a mechanism.

## 3. Empirical evidence

This section presents descriptive statistics highlighting the importance for social relations in the decision to adhere to informal financial practices that are embedded, albeit to different degrees, in a reciprocity mechanism. Such statistics allows shedding some light to the rationale behind the demand for financial services. In total, six financial practices were identified. They include formal practices such as traditional banks, Microfinance institutions (mainly credit and saving cooperatives) as well as informal practices such as Roscas called Pari, moving bankers known as

Cauri d'or[10], commercial advances or supplier credits – the most popular supplier credit is the taraogo[11] – as well as loans between friends.

### i. Sample and data

A random sample of 398 micro-entrepreneurs was selected from the markets of Nabi Yaar, Rood Woko and Dasasgho located in Ouagadougou, the Capital City of Burkina. The total population in these markets amounted to about 6,500 micro-entrepreneurs. The selected micro-entrepreneurs were submitted to a detailed survey containing among others a module designed to collect information about the participation of the respondents to the various financial practices as well as module made of qualitative questions aimed at identifying the reasons behind the decision to use each of the identified financial practice. The methodology adopted in this module consists in asking directly the respondents to give reasons behind their decision to use a particular financial practice such as to identify a number of motives that could explain their behavior. A particular attention is devoted to motives that are related to social relations.

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### ii. Financial participation

During the survey, micro-entrepreneurs were asked to indicate all the financial practices they ever used including those they were no more using. This information was useful in assessing financial participation through the analysis of the global enrollment rates; the drop out rates as well as the actual enrollment rates (see figures 1 & 2):

- *The global enrollment rate* indicates the proportion of respondents who declare to have used a particular financial practice even though this may no longer be the case.
- *The actual enrollment rate* indicates the actual proportion of respondents who are still using a particular financial practice.

[10] The cauri d'or is a financial practice by which an individual called "tontinier" takes the responsibility of collecting and keeping the savings of several other people. Each member of the cauri d'or decides to save a given amount of money every day. The collected amount is recorded in notebook (diary) left at the disposal of the member

[11] Taraogo is a sort of purchase credit whereby the micro-entrepreneur is supplied by a colleague or a wholesaler and he accepts to pay a fix amount every day until he pays back the entire amount of the credit

*Figure 1: Enrollment rates (global and actual)*

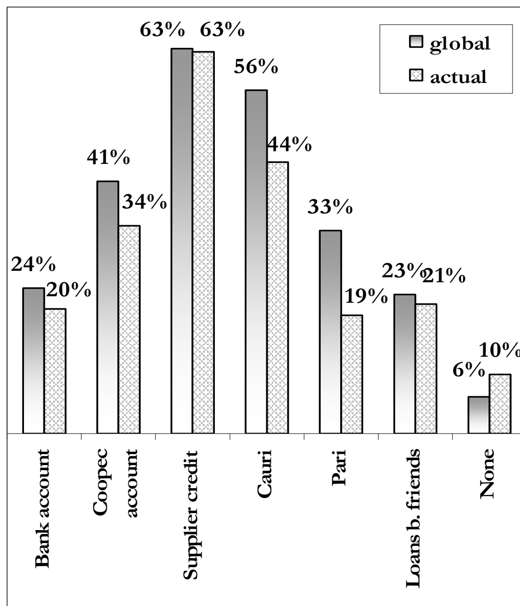
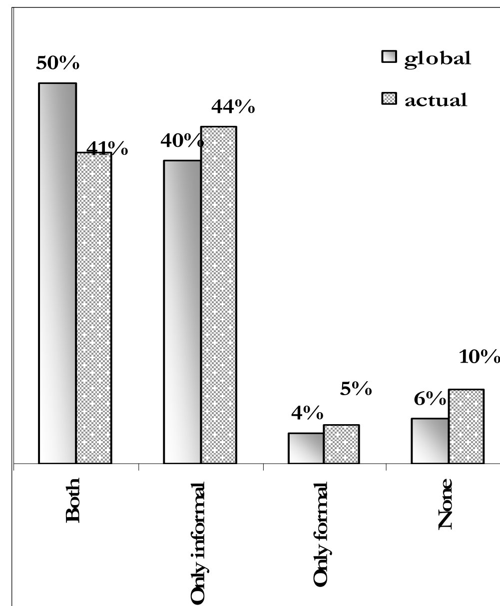



*Figure 2: Informal vs. formal*




From figure 1, it appears that *Supplier credits* constitute the most popular financial practice with global and current enrollment rates of about 63% (actual 63%) each. The next practice is the *Cauris d'or* with a global enrollment rate of 56% (actual 44%). Both Roscas Pari and Loans between friends account for less than 30% each. Considering formal financial practices, we observe that *cooperatives* are the most popular with a global enrollment rate of about 41% actual (34) while traditional banks' enrollment rate is only of 24% (actual 20%). Finally, only 6% of the respondents have never used any of the identified financial practices. At the time of survey 10% of the respondents were not engaged in any financial practice.

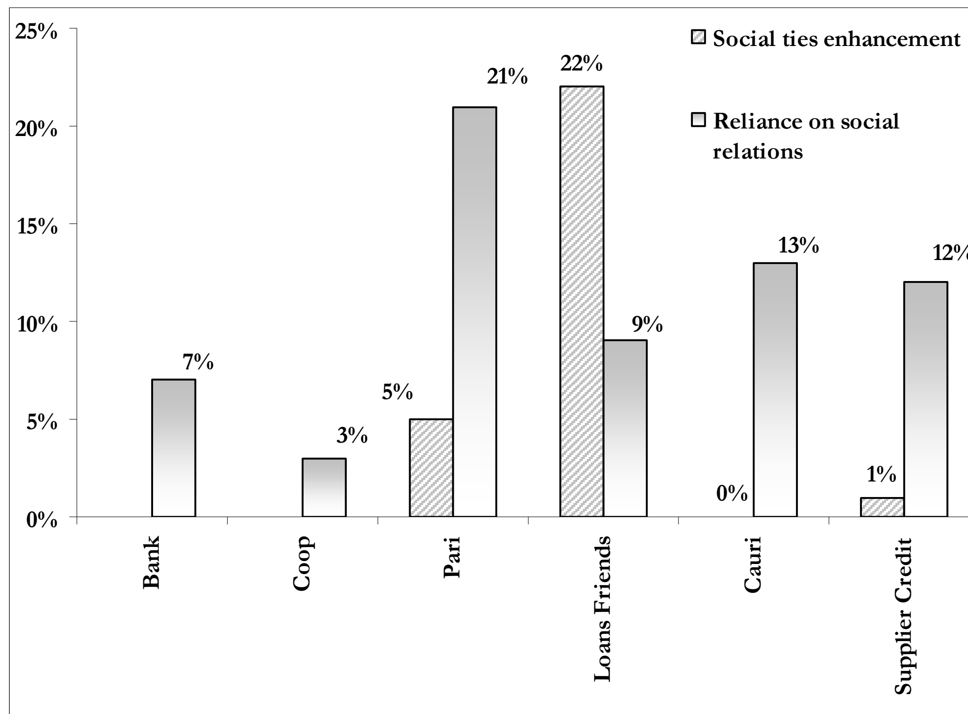
The next figure (figure 2) shows that about 50% (actual: 41%) of the interviewed micro-entrepreneurs are active in both formal informal financial markets. This finding is in line with Morvant-Roux (2009) and Guérin et al (2010) who showed that the access to formal microcredit does not prevent individuals from using informal loans. However, while these findings relate exclusively to the use of informal credit in rural areas, the finding presented in this study is not restricted neither to credit markets and applies to urban areas. It shows clearly that a significant number of micro-entrepreneurs operating in the city of Ouagadougou juggle both formal and informal financial instruments in order to meet their financial (saving and credit) needs. It constitutes an additional empirical evidence against the idea that participation to informal finance is triggered by the lack of access to formal financial markets.

### iii. The importance of social related motives

Figure 3 depicts the proportion of micro-entrepreneurs who declared that social relations have played an important role in their decision to enroll in the identified financial practice. It appears clearly that this proportion is more important for informal financial practice than for formal financial practices. This suggests that the impact of social relations is likely to be more important in informal financial practices.

Roscas (Pari) are more prone to rely on social relations i.e. individuals accept to join Roscas when they know the other prospective members. As such, individuals joining Roscas have the opportunity of enhancing their existing social relations but at the same time these social relations constitute a source of confidence about the reliability of the other members. In the same vein, involvement in loans between friends is more likely to be triggered by the need to maintain (enhance) good relationship with friends.

*Figure 3: Social related motivations Motives*



## 4. Concluding remarks

Given the above results, it appears that social relations are likely to be operational in explaining financial behavior of micro-entrepreneurs operating in urban sub-Saharan African markets. Particularly, micro-entrepreneurs participating in informal financial practice such as Roscas, Cauri d'or and loans between friends seem to be more inclined to take their decisions for reasons related to social relations. This suggests clearly that social relations constitute a non negligible motive for participating to specific informal financial practices. A direct implication of this finding is that such informal financial practices will tend to persist even if formal financial practices are available and accessible. However, this hypothesis needs to be confirmed through a detailed econometric analysis which allows controlling for a number of variables susceptible of affecting individuals' financial behavior. .

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