Credit for Rural Development:
Trends of Formal and Informal Credit Sources in Sri Lanka

By
D.P.S. Chandrakumara, PhD
Senior Lecturer in Economics
Department of Economics
University of Sri Jayewardenepura
Gangodawila
Nugegoda
Sri Lanka

Email: chandrakumara62@gmail.com

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Abstract

The aim of this paper is to identify how far the rural institutional and non-institutional credit sectors of Sri Lanka have been changed during the last several decades. The study used only the simple descriptive statistical methods for the analysis while it was totally dependent on the secondary data obtained from the institutional sources. The literature on development theory was helpful in identifying the need for and the role of credit in rural development.

The study reveals that a rural household, which is not much different in size from that of the urban, allocates a higher percentage of their expenditure on food and drinks due to the relatively low income. However, the income inequality of the rural sector is lower than that of the urban. Although the network of the institutional lending institutions has been continually expanded, the increase of its relative share has not been so large. Furthermore, albeit the subtle contraction, the informal sector still plays a significant role in the provision of rural credit. However, some informal credit sources, which are based on traditional or social relationships, are even better than the formal sources since they are of unconditional type. However, the significance of such amiable sources seems to have been decreasing. Easy access, freeing from collateral requirements and flexibility are the most attractive qualities of the informal credit sources while the higher cost of loans to the borrower caused by higher transaction cost is a main problem of the formal sector. Although there are borrowers, who demand credit from both sectors, the supply-side of credit shows no explicit relationship between the formal and informal lenders.

The study identifies that the formal sector can be further expanded by adopting the procedures of successful formal sector financial institutions and good qualities and strategies of the informal moneylenders. Informal activities should be transformed into formal through the interference of the Central Bank. Peasants should be educated about the formal sector while introducing attractive investment programs for the informal

moneylenders instead of lending to the poor. Alternatives should be adopted in place of the collateral requirements when loans are grated for the poor.

Key words: Rural credit, Formal sources, Informal sources

1. Introduction

Almost all developing countries are characterized by a large rural sector. Being capital scarce, labor abundant and the livelihood of majority of people are land-based activities, credit was assumed to be as one of the key determinants of the development of this sector as of 1960s. Hence, the rural credit market has to play a crucial role for the development of people and the economy of this sector. A credit market of an economy should consist of the supply and demand sides. The supply side of the rural credit market consists of formal (or institutional) credit sources and informal (or non-institutional) credit sources. Formal credit sources can be introduced as the banking and other organized institutions, which have been registered under the Central Bank of Sri Lanka and therefore subject to the regulation and supervision. However, this sector may include the institutions such as thrift societies since such institutions have some kind of organization and control even if they have not been under the regulatory framework of the Central Bank. The informal sector consists of unorganized financial sources such as moneylenders, shopkeepers, pawnbrokers, friends and relatives, landlords and employers who provide credit in any form with or without an interest payment.

Since independence, especially after 1960s, Governments of developing countries and international institutions and agents involved in the developmental or poverty alleviation issues paid more attention on rural financing programs. This is because they identified that the informal credit providers were unkind for the peasants, micro-entrepreneurs and the entire process of rural development. The peasants would never escape from the poverty trap unless such detrimental financial activities are replaced by appropriate institutional credit schemes. In line with this view, Sri Lanka also attempted to expand the role of the institutional sector in rural development for decades introducing different kinds of credit schemes. This paper attempts to identify what kind of trends the rural formal and informal credit sectors have been experienced during the last several decades in Sri Lanka.

The paper unfolds in six sections. After the introduction, Section 2 presents the objectives of the study. Section 3 briefly explains the methodology, data sources and the limitations of the study. Section 4 provides the theoretical basis for the need for and the role of credit in development. Section 5 consists of three sub-topics namely economic status of the rural sector households, sources of rural credit and the significance of the formal and informal sources in the provision of credit. Finally, Section 6 draws conclusions and policy implications based on the results of the study.

2. Aim and Objectives

The aim of the study is to identify the trends of the rural credit market during the last several decades in Sri Lanka. In order to assist the aim, the study intends to achieve the following specific objectives:

1) To identify how far the formal sector financial service has expanded in the rural sector.
2) To identify whether the significance of the informal moneylenders has been changed in the rural sector during the last several decades.
3) To distinguish between formal and informal credit in terms of interest rates, transaction costs and the responsiveness to borrowers.

3. Methodology, Data and Limitations

This study employed descriptive statistics such as bar graphs, line graphs, radar and statistical tables. Key variables of the study were number and amount of loans granted, , percentage of households obtained loans, number of institutions and their branches and service outlets, interest rate of the banking and other financial institutions dispersed within the country, transaction cost of borrowing loans and some qualitative characteristics related to the formal and informal sectors.

The study completely depended on secondary data obtained from the reports of the Central Bank of Sri Lanka and the Department of Census and Statistics. In addition, reports of international institutions and studies of individual researchers were used. Basic data obtained from some reports were further processed and presented in a more conducive way to understand the trends.

The study was, however, not free from limitations mainly associated with data. Reports of different surveys and also different institutions have used different definitions and methods for their surveys. This affects when the comparisons are made between surveys. Furthermore, data is not available to cover all the necessary sections of the issues discussed by the study with approximately relevant time gaps during the entire period. However, despite all these limitations the study attempted to maximize the validity of the conclusions addressing the main questions given under the objectives.

4. The Need for and Role of Credit in Development

Development credit plays a crucial role at national, regional or entrepreneurial levels despite the stage of development of a country. Practically, it is understandable that the gap between the required amount of financial resources and the truly available amount is equivalent to the need for funds or credit. However, beyond this accounting kind of clarification there are very solid theoretical justifications for credit in the theoretical literature of development.

The general theories of development, which are available in the development literature, are strongly in the stand that capital accumulation within the process of production is essential for the development. The accumulated capital should be continuously reinvested in the production itself in order to continue the accumulation and the development processes. Such a process will generate the necessary funds for development within the system itself. However, due to the limitation of capital accumulation, it does not generate sufficient funds for development. Developmental credit plays a crucial role when countries or entrepreneurs face such a deficiency in the accumulated capital.

In addition to general theories, partial theories of development more specifically show the need for development credit especially for underdeveloped or developing countries. Nurkes (1960), in his popular book, '*Problems of Capital Formation in Underdeveloped Countries*', points out that there is a vicious circle of poverty that trap the poor in the same state. A circular constellation of forces tends to act and react upon one another on the supply side as well as on the demand side. On the supply side (Figure-1), low level of income of the poor supplier becomes the cause of small capacity to save. The low real income, which is an indicator of low productivity, is the cause of lack of capital. However, since this cause effect relationship takes the form of a circle, there is no initiating point to be found within the circle.

Firegure-1: Supply-side Circle

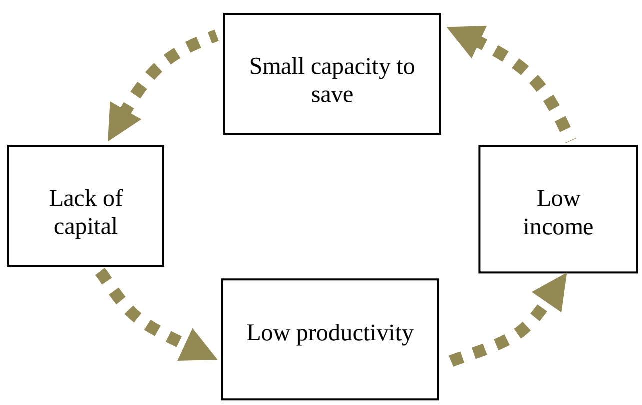
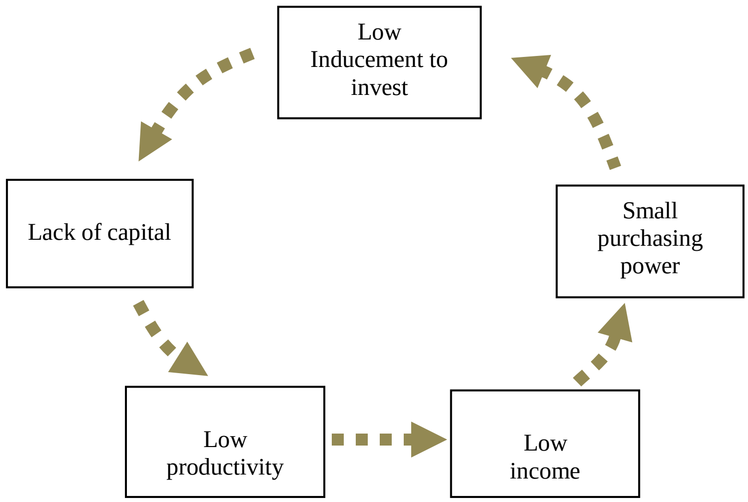


Figure-2: Demand-side Circle



Similarly, on the demand-side, small real income that tends to lower the purchasing power of people and reduces the inducement to invest is the result of low level of productivity. The low productivity is again the result of the inadequacy of capital used in the production. This shows that there are two sets of circles working in the underdeveloped economies trapping the poor in the poverty status. However, Nurkes points out that there is one common key factor in both circles that can be manipulated for moving away the poor from poverty using the same circular cause-effect relation. This key factor is the '(lack of) capital' used in the production process. An increase in the amount of capital will increase the productivity leading to increase the real income and in turn saving, purchasing power and the inducement to invest. It shows that addressing the problem of 'lack of capital' effectively solves all other problems such 'as low productivity', 'low income', 'small purchasing power' and 'low inducement to invest', which are seen in the demand-side circle. This is one of the strong points that is available in the history of theoretical literature with regard to the need for credit in development. Furthermore, the balanced growth strategy suggested by Nurkes and some others elucidates the fact that the simultaneous investment in all sectors is a necessary requirement for an interdependent growth of all sectors. This highlights the significance of credit in economic development since the application of such a development strategy is not possible without credit in capital scarce countries.

Rosentine-Rodan (1943) also pointed out that the underdeveloped countries needed a big push to overcome different kinds of barriers and have a growth potential. In other words, these countries require large amounts of capital as investments in order to break the bonds that an economy prevails with backwardness. Small scale investments would waste the resources since it would not be strong enough to break such bonds and push the economies forward. This theory is relevant for both national development of a country or development of an individual entrepreneur who is not still self-sustained. Hence, this theory is helpful to understand that credit is crucial for underdeveloped countries as the big push they need cannot be made without the support of credit.

Leibestein's (1957) Critical Minimum Effort Theory is also important in understanding the need for credit for development. This theory highlights the relationship between three factors, (i) per capita income, (ii) population growth and (iii) investment. According to him investment is an income-generating factor while the population growth is an income-depressing factor. The growth can be realized only when the income-generating factor becomes more powerful than the income-depressing factor. If the affordable capital investment is not sufficient so as to become so powerful, the growth is not possible for the reason that the net effect on income would be zero or negative. Hence, initial effort for development in the form of investment should be above a certain minimum level. However, being the poor, it is not possible to invest such large amounts in individual or national development levels. This elucidates that the developing countries or the poor need credit since there is a deficiency of the accumulated capital or the existing funds or savings to make the critical minimum effort for development.

The Capability Expansion Approach of Sen (1990) is also helpful in understanding the need of credit for the people who are in poverty. Even if they are poor in physical resources, they still have capabilities that they can expand in many forms. For example, they can improve their knowledge and skills through education and training, transforming them into valuable human capital, which can generate more incomes by increasing the productivity of labor. Hence, rural credit can be used for the expansion of capabilities of the poor.

The above are only some of the theories that show the need of credit either at national level or individual level development of people. The need of credit for rural development is even more important since the majority of the population in the rural sector in developing countries consists of the poor such as peasants, small farmers, landless farming laborers, artisans, small fishermen or otherwise paupers, who are considered as not creditworthy. A proper credit system that serves the rural sector is essential for the generation of more employment opportunities, maximum utilization of other under-utilized resources, etc. while raising the incomes of the rural poor. However, it is often said that the rural credit market is not working well for the poor (Karmakar, 1999: Mohapatra, 1997). Having identified this problem, every government, which came into power in Sri Lanka during the last several decades, attempted to encourage the formal credit sector while discouraging the informal moneylenders. Therefore, it should be examined how far the formal and informal credit sectors of the rural economy has been changed in response to the formal sector adjustments and the other changes of the rural economy.

5. Analysis

5.1 Economic Status of Rural Households

Measuring economic status of rural households in terms of the level of household income is not in fact realistic since most of them earn an income in material form too. Besides, obtaining information about the incomes of households is not an easy task because people hide their actual income due to various reasons. Although there is a possibility of avoiding this problem using composite assets indexes, still there is no such an index has been constructed to measure the economic status of the island-wide households in Sri Lanka. As such, the available measures, which are more close to financial income of households, are mostly used. In addition, indicators such as food ratio, income distribution and poverty indicators are also used for obtaining a more realistic picture of households' economic situation.

It is generally expected a larger household size from the rural sector than it is in the urban sector. However, data suggests that the average number of members in a rural household is little smaller than an urban household. The ratio of expenditure on food and drink as a percentage of total expenditure is called as the food ratio (Dept. of Census and Statistics, 2008). This ratio, being substantially high in the rural sector, shows that a share of more than two fifth of household expenditure of the rural sector is allocated for food and drinks while it is little more than one third in the urban sector (Table 1). All the income indicators, which are given in Table 1, show that the rural sector is in a very low position in income compared to the urban sector. This is more explicitly reflected by the poverty indicators such as head count index, percentage of poor households and poverty gap index which have been prepared for the rural sector as well as for other sectors of the economy. However, in the case of the extent of household income inequality indicated by the GINI ratio, it shows that the inequality of the rural sector is lower than that of the urban sector.

Table 1: Indicators of Rural Household Economic Status

Economic Status Indicator		Rural Sector	Urban Sector
Average household size		4.0*	4.3*
Food ratio		40.6%	34.4%
Income	a) Mean household income	Rs. 34,323.00	Rs. 46,196.00
	b) Per capita income per month	Rs. 8,744.00	Rs. 11,143.00
	c) Mean household expenditure per month	Rs. 30,805.00	Rs. 44,845.00
	d) Income receiver's mean income per month	Rs. 19,211.00	Rs. 24,112.00
Poverty	a) Head Count Ratio	7.7%	6.5%
	b) Percentage of poor households	13.1%*	5.0%*
	c) Poverty gap index	3.2%*	1.3%*
GINI co-efficient of household income		0.38	0.39

Source: Department of Census and Statistics, 2011, 2008*.

5.2 Rural Credit Market

5.2.1 Formal Credit Sources

The formal credit market in Sri Lanka has been expanded continuously in terms of number of banking and financial institutions, number branches, etc. since independence. The government policy also contributed to the expansion of the institutional financial sector. Available evidence shows that state banks are more popular with having more than 75 percent of household savings in state banks (GTZ, 2008). In contrast, informal credit market has been discouraged through various government actions and policy interventions because it is regarded as harmful to the rural sector development. As a response to the government monetary and banking policy integrated with the economic liberalization policies, all kinds of financial institutions expanded and spread throughout the country except in the war-affected areas. All the institutions involved in saving and/or lending business in the country can be divided into three main categories:

1. Licensed Commercial Banks (LCBs)
2. Licensed Specialized Banks (LSBs) and
3. Non-bank financial institutions.

First category, LCBs, is the most important in the point of view of the liberalization of the economy. The expansion of commercial banks in the country is an indication of the commercialization of the economy. Table 2 shows that 5014 branches including other service centres, which belong to 22 banks, are being operated in the country by 2009. A substantial number of these bank branches is either situated in the rural sector or provided their services to the rural sector.

Table 2: LCB and LSB Branches and Outlets

Category	2009	
	No.	Branches
Total No. of LCB branches and other outlets	22	5014
Total No. of LSB branches and other outlets	14	689
Banking density (No. of LCBs per 100,000 persons)	10.8	

Source: Central Bank of Sri Lanka, 2009.

Table 3: LSBs – Distribution by Institution and Branches

Category	No. of Institutions	No. of Branches
1. Regional Development Banks	6	226
2. National Savings Banks	2	147
3. Long-term Lending Institutions	2	21
4. Housing Finance Institutions	2	28
5. Private Savings and Development Banks	2	43

Source: Central Bank of Sri Lanka, 2010.
GTZ/BWPN, 2009

The second category of the institutions, LSBs, does a big role in the rural development of Sri Lanka. The five major sources of this category are Regional Development Banks, National Development Banks, Long-term Lending Institutions, Housing Finance Institutions and Private Savings and Development. Some of these institutions have especially been established with the main purpose of rural development. The number of LSBs situated in the country by 2009 is 14 while they are operating the activities through 689 branches including the service centres (Table 2 and Table 3). Hence, the total number of branches and service centres of LCBs and LSBs in the country has been 5,703 by 2009.

Table 4: Non-LCB-LSB Institutional Network of the Country

Category	No. of Branches
Other Institutions	
Registered Finance Companies	31
Specialized Leasing Companies	20
Primary Dealers	11
Merchant Banks	10
Stock Broking Companies	20
Unit Trusts	14
Venture Capital Companies	7
Employees Provident Fund	1
Co-operatives	
C-operative Rural Banks	1,628
Thrift Credit Co-operative Societies	8,440
Public Welfare Organizations	
Samurdhi Bank (Branches)	1,038

NGOs	250
Insurance Companies	16

Source: GTZ/BWPN, 2009

The third category constitutes all non-LCB-LSB institutions of the country, which are given in Table 4. This category includes 12 sub-categories including 'Cooperative Rural banks' and Thrift Credit Co-operative Societies which are very popular sources of credit among the rural poor. A part of the thrift societies has been organized under Sanasa while the other societies are still operated independently (GTZ/BWPN, 2010). Samurdhi Bank Societies (SBSs), established in 1996 with the introduction of the Samurdhi Program which is one of the main poverty alleviation programs of the government. Number of Samurdhi bank branches of the country has been recorded to be 1,040 in 2009. Both local and international NGOs are also operated with various types of saving mobilizing and funding activities of the rural economy. Leasing companies mostly provide the service for middle income earners who can demand leasing or loan facilities mortgaging their land and capital assets. Leasing has been an important method of credit when people purchase rural agricultural and transport equipment.

The institutional network of the credit market in Sri Lanka is not unsatisfactory in terms of the number of institutions. However, all these institutions do not equally provide their service to the rural sector development due to various reasons. It may be correct to articulate that a substantial number of institutions are situated in the rural sector for the service of the rural sector.

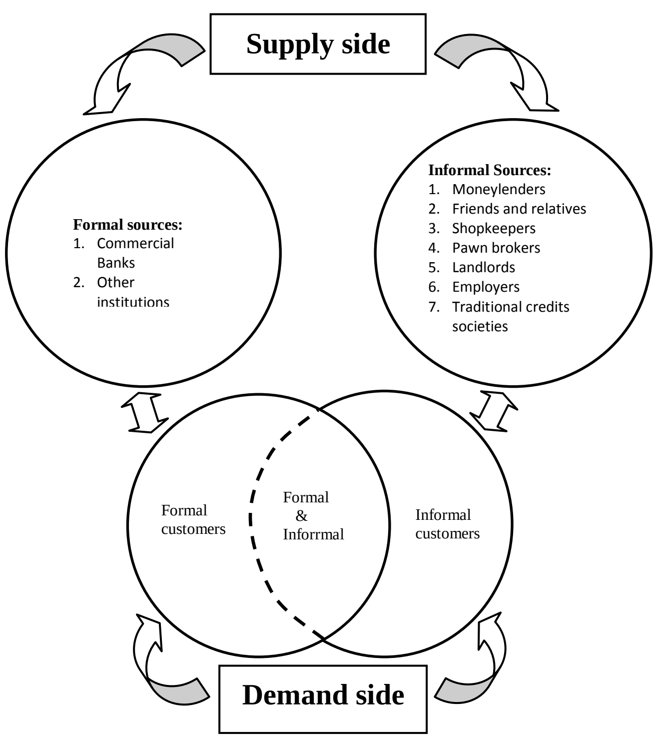
5.2.2 Informal Credit Sources

Informal credit sources consist of those who provide credit in financial or material forms without legal permission or registration as credit providers under the Central Bank of Sri Lanka. They may be professional moneylenders who earn an interest income or lenders seeking benefits other than interest income or friends or relatives who do not expect any form of return for the loans provided. All these lenders can be classified into three categories as follows based on the findings of main surveys conducted in Sri Lanka.

a. Professional moneylenders
b. Shopkeepers
c. Friends and relatives

First category, professional moneylenders, is engaged in the provision of credit to their nearby villagers for production or consumption purposes. Second category, shopkeepers or boutique holders, mostly provides goods, either consumables or input needs of the agricultural or other products on credit. Third category, friends including neighbors and relatives, is the only lenient source of credit among the informal sources of credit. In addition, pawnbrokers, landlords, employers and rotating savings credit associations are also the informal sources of credit which are common to all sectors (GTZ, 2008). Not like in the organized money market, informal moneylenders operate within smaller boundary limits or clusters without a link between them. For example, a shopkeeper sells goods on credit to nearby customers that he knows well since they are dwellers of that small area. Monopolistic features may also be seen when the business is limited to a single lender within the cluster. The informal sources of credit are common to both urban and rural sectors of the country.

Figure 1: Rural Credits



Source: Created by the Author

Some researchers have seen the formal and informal transactions as a dualistic feature of the rural credit market (Tilakaratna, 1996). This is absolutely correct when we consider the supply side of the rural credit market because there is no purposive link between formal and informal lenders. However, in the demand-side of credit, some borrowers involve in transactions with both formal and informal lenders. GTZ (2008) shows that out of the 18.5 percent households who utilized informal credit, 8.6 percent had access only for informal credit. The remaining 10.3 percent of borrowers (out of 18.5 percent) had utilized credit from both formal and informal sources. This situation is indicated by Figure 1.

5.3 Significance of the Formal versus Informal Sources in the Provision of Credit

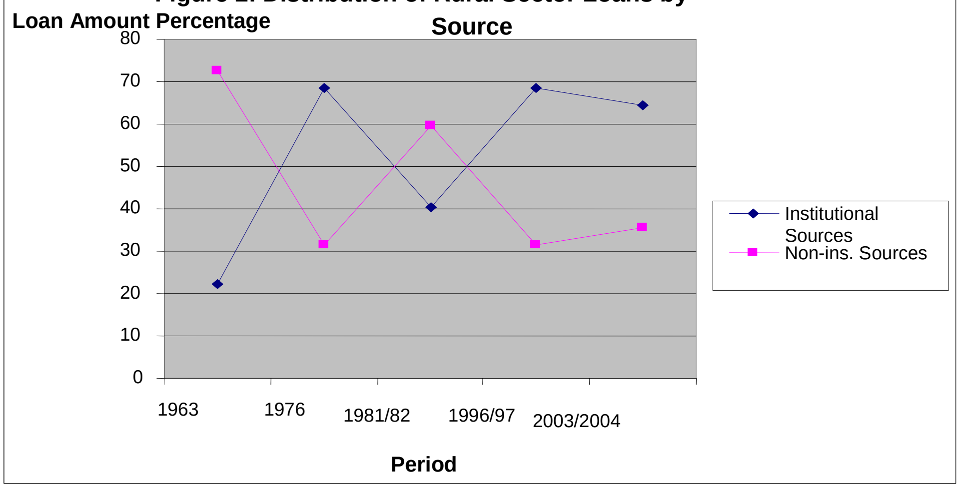
Section 5.2.1 revealed that the formal sector of the credit market has been substantially expanded and a large number of different kinds of banks and non-bank institutions had been involved in financial transactions. However, it is not merely the density of financial institutions that determines the role of the institutional sector. The real contribution is reflected through how sufficiently they have contributed to granting of loans especially for the poor to promote their production and raise their incomes. Table 5 shows the relative contribution of the two sectors, formal and informal sectors, in granting rural sector credit.

Table 5: Contribution to Rural Credit by Source and Time

Source	1963	1976	1981/82	1996/97	2003/2004
1. Formal Sources	**22.3**	**68.5**	**40.3**	**68.6**	**64.4**
2. Informal Sources	**72.7**	**31.5**	**59.7**	**31.4**	**35.6**
a. Money Lenders	26.2	16.5	20.3	9.2	7.6
b. Friends & Relatives	38.7	12.4	29.2	21.1	26.5
c. Other Informal Sources	12.8	2.2	10.2	1.1	1.6

Source: Central Bank of Ceylon, 1964.
Central Bank of Sri Lanka, 1981, 1984, 1999 and 2005.

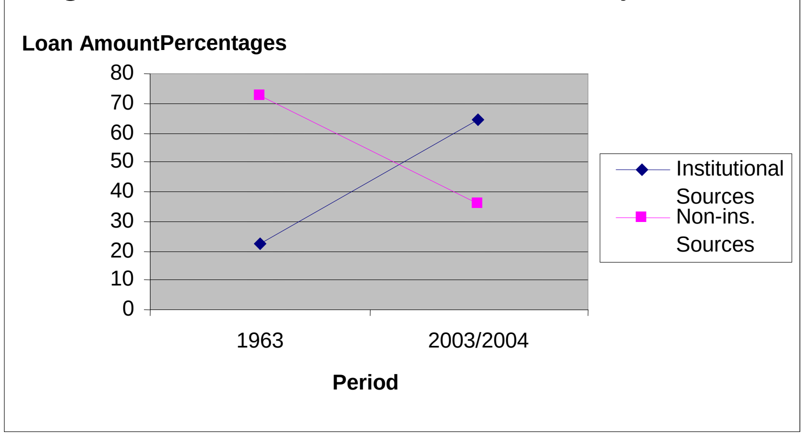
Figure 2: Distribution of Rural Sector Loans by Source



Source: Created by the Author through data in Table 3.

Table 5 and Figure 1 do not in fact show smooth paths of reducing the relative importance of the informal sector while increasing the relative importance of the formal sector. It is quite irregular as the importance of the informal sources has again increased to a high level during 1980s. However, if the period between 1993 and 2003/2004 is ignored, the two points between the 1960s and 2003/04 can be connected by the lines as shown in Figure 3. It means that the relative significance of the formal sector in granting loans in the rural credit market has substantially increased. It also reveals that despite the huge expansion of the institutional credit network, the non-institutional or informal sector still remains around 36 percent of total rural sector loans.

Figure 3: Distribution of Rural Sector Loans by Source

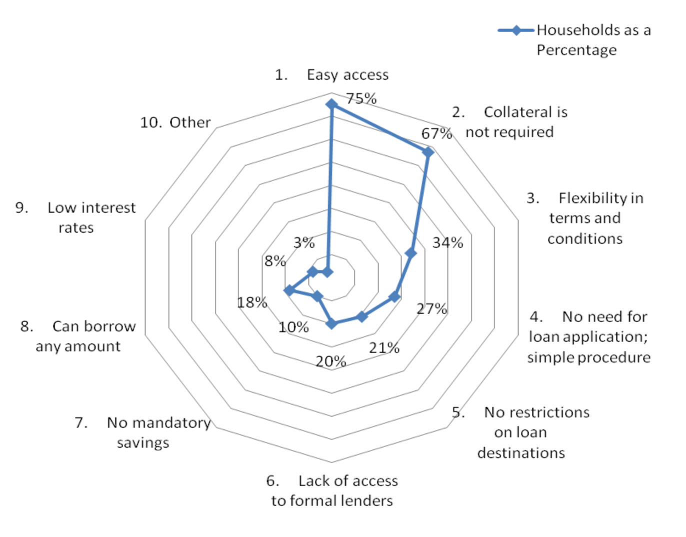


Source: Created by the Author through data in Table 3.

Furthermore, Table 5 shows that within the informal sector, the relative significance of moneylenders has continuously declined up to 2003/2005. This is due to the expansion of the network of the institutional credit sources of the village economy. The relative significance of the loans, which were obtained from *friends and relatives,* also show a slightly decreasing trend.

GTZ (2008) reveals why a large percentage of borrowers still depends on informal sources of credit. Figure 4 shows that reasons, 1, 2 and 3, respectively '*easy access*', '*collateral is not required*' and '*flexibility in terms and conditions*' are the most important reasons for the still remaining high dependence of the borrowers on informal lending sources. Among the three reasons, 1 and 3 are reasons that can be further minimized by increasing the flexibility of lending via lessening of conditions and removing the still remaining barriers to access to loans. In the case of reason 2, collateral requirement, institutions can apply practically viable alternative innovative methods or methods that are already successfully applying by some micro finance institutions in some countries. The remaining reasons, from 4 to 5, are mostly related to the reason 1, '*easy access*'.

Figure 4: Reasons for Borrowing from Informal Sources



Source: Constructed by the Author using data of GTZ, 2008.

Peasants mostly depend on informal sources mainly because there is a mismatch between the two sides, lenders and the borrowers. Informal sources of credit have got the attraction of peasants since it gives the impression of being borrower friendly and free of conditions. However, practically, these sources that provide only short-term small size loans regardless of the purpose of the peasants are neither helpful to the peasants and nor supportive for the rural development. Especially, informal moneylenders are criticized as exploiters of rural peasants through their credit traps where the peasants can never escape from. Even though there is an easy access to informal credit, there is no easy way to evade them because the moneylenders have their own strategies to trap the borrowers. Furthermore, the rates of interest of professional moneylenders of the informal sector are exceptionally high compared to that of the formal sector.

The information on the rates of interest of both formal and informal moneylenders can be found from different surveys and studies. Table 6 summarizes the interest rates and related details of the formal and informal sectors of the rural credit market in Sri Lanka based on the reports of several major surveys conducted during the last several decades. The rate of interest of informal moneylenders was 22 percent per annum in 1963 while it was only 7-8 percent in the formal market. This is about three times higher than the rate charged by the formal sector institutions.

Table 6: Interest Rates by Survey

Survey	Year	Source	Informal Sector	
			Percentage of loans with high interest rates	**Interest rate (Annual Average)**
Consumer Finance Survey	1969	CBSL	For 12% of loans	More than 20%
Consumer Finance Survey	1973	CBSL	For 15% of loans	More than 20%
Credit and Indebtedness among Paddy Farmers	1976	CBSL	For 17% of loans	More than 50%
Consumer Finance & Socio Economic Survey	1978/79	CBSL	For 15% of loans	More than 30%
Consumer Finance & Socio Economic Survey	1981/82	CBSL	For 15% of loans	More than 100%
Consumer Finance & Socio Economic Survey	1985/86	CBSL	For 11.8 % of loans	More than 100%

Consumer Finance & Socio Economic Survey	1996/97	CBSL	For 3.4% of loans	More than 100%
Consumer Finance & Socio Economic Survey	2003/2004	CBSL	-	-
Sri Lanka Connecting Regional Economies	2009	USAID/ CORE	18.5% (Households using informal credit)	More than 100% (5-20% per day)
Microfinance Industry Report	2009	GTZ/ BWTP	18.3% (Households using informal credit)	-

However, as it has already been identified, the causes which avert the peasants from formal credit sources are very strong. For example, additional cost incurred in loan transactions which is called 'transaction cost' is very high for the borrowers of the formal sector. This includes the costs other than the interest payment that the borrower has to spend for obtaining the loan during the loan process for the needs such as food and traveling expenses, application fees, tips for the services for different persons and other expenses down to the loan transaction and borne by the loan applicant from his pocket. Hence, the cost of loans for the borrower constitutes interest cost plus transaction costs. Some researchers have found that minimization of transaction cost of lending as a critical factor that determines the success of the formal credit sources (Tilakatarna, 1996).

Transaction cost is especially high in the case of less educated rural borrowers because of the dearth of contacts, difficulty to understand loan procedures, etc., the loan process becomes longer in period, costlier and more complicated for them. A study conducted in two selected districts in Sri Lanka reveals that the transaction cost is relatively high for the applicants of small loans. It shows that the transaction cost of small scale loans that ranges from Rs. 1800.00 to 2600.00 is high about 74 percent of the total borrowing cost whilst it declines to about 34 percent with the increase in the scale of loans up to Rs. 18,000.00 (NORAD, 1990). However, the transaction cost incurred in non-institutional loans is nearly zero since such loans are obtained from nearby lenders, easy to understand and not subject to a long process of complicated procedures. It is on this ground that a substantial proportion of rural borrowers still stay with informal moneylenders.

Another important point for the less attraction of the formal sector is that the formal dealers are less responsive to the behavior of rural peasants. Officials who are unfamiliar to peasants and their activities, uneasy terms and conditions, bureaucratic responses, complicated application procedures, etc. have still not been totally disappeared from both government and other financial institutions. Furthermore, a high percentage of peasants are not eligible to obtain a loan from these institutions since they do not posses a permanent job or income, fixed assets with clear title deeds and qualified guarantors and other forms of collaterals for loans. In contrast, the non-institutional sector possesses informal strategies conducive with the qualifications and the behavior of informal loan applicants. Loans without collateral, little documentation and rapid disbursement are the major elements that push the peasants to depend on non-institutional loans with higher interest rates (USAID/CORE, 2009). They can obtain instant credit from village money lenders or shopkeepers without getting into many formalities and time delays. Since moneylenders know all about the borrowers, they have their own strategies to recover loans with the interest payments or other benefits that they expect from the borrowers. Moreover, there is no supervision on whether the loans are used on the relevant purpose of the applicants. However, the peasants are trapped by the moneylenders by various ways and exploit them through very high interest rates, other forms of payments and informal conditions. For example, the farmers obtain consumables on credit basis from the village shopkeeper on the condition that they repay the loan at the end of the season after the harvest. The settling of the credit account is either by cash or most probably by material form of harvest, if it is profitable for the shopkeeper. This condition avoids the peasants from earning a higher income by selling the farm produce in the open market. Low-income again keeps them in low saving and investment which leads to dependency on informal sources of credit for their capital and consumer requirements so that trapping them in the vicious circle of poverty. Therefore, this has been a greater obstacle to rural development which continues for decades despite the government effort to minimize it through expanding the institutional credit sector.

However, it does not mean that all lending sources of the informal sector are harmful to the peasants and the rural development. The least risk source of credit in the point of view of the borrowers also belongs to the informal sector. Peasants are able to borrow money from friends, including neighbors, and relatives without any financial or material collateral. However, such loans may have only ethical kinds of bonds that can be created between the borrower and the lender. A substantially high percentage of rural sector cash loans are the loans that peasants obtain without collateral (Table 7). Loans which are granted on collaterals such as personal guarantees, jewelry/consumer durables, etc, happen to be the secondly important in the rural sector while the immovable property and machinery/Pro-notes/EPF/Other are the least important.

Further, the informal lenders can engage in business being in their own home or in the street while they can simultaneously engage in some other businesses (World Bank, 1989). Since the customers are the people they meet in day today activities, these lenders know how to recover the loans with due interest payment. However, formal lenders have no such closeness to the borrowers.

Table 7: Distribution of Amount of Cash Loans by Collateral in the Rural Sector

Type of Collateral	Percentage of Total Loan Amount
No security	34.2
Personal guarantee	22.4
Immovable property	10.6
Jewelry/consumer durables	19.8
Machinery/Pro-notes/EPF/Other	13.0
Total	**100.0**

Source: Central Bank of Sri Lanka, 2005.

Commodity loans are also an important way of credit transactions in the rural sector. This includes either direct transactions of commodities by peasants and purchasing of commodities – consumables or inputs – on credit from shopkeepers. These loans are mostly based on the trust that has been created for some time between the lender and the borrower. Table 8 shows that nearly 40 percent of households borrow commodities from the retail shops in the rural sector.

Table 8: Percentage of Households Borrowed from Retail Shops in the Rural Sector

Year	Percentage
1996/97	32.0
2003/04	38.0

Source: Central Bank of Sri Lanka, 2005, 1999.

Considering all the facts with regard to the rural credit market in Sri Lanka, it is clear that although the formal sector of credit has been gradually expanded, the significance of the harmful sources in the informal sector is still important. The government sector institutions, where the majority of people have been concentrated with, are to some extent responsible for this situation because they are not still using more pragmatic, customer-oriented methods of mobilizing savings and financing the needs of the rural peasants. However, it seems that some non-governmental institutions that are engaged in micro-financing are successfully approaching the rural poor introducing innovative methods of saving and financing. The institutions in the formal sector should learn from such successful institutions and the informal moneylenders and introduce more competitive innovative strategies to finance the rural economy.

6. Conclusions and Policy Implications

6.1 Conclusions

Although there are some differences in the methodologies among the surveys and studies that were used in this study, it is still possible to safely draw conclusions on the rural credit market in Sri Lanka.

1. It seems that the network of the institutional lending sources has been continually expanded during the last several decades in terms of the number of outstation

branches. However, the relative share of the rural sector institutional credit has not been expanded in comparison to the expansion of the institutional credit market. Hence, the meaning of the expansion of the institutional network in the rural sector has not been so far satisfactorily realized in terms of the service rendered for the needy people.

2. Although the informal sector has slightly contracted in response to the expansion of the formal credit sector, it still plays a significant role in the rural credit market.

3. All informal credit sources are not equal in terms of the effects on the rural poor. Among the informal sources, the loans with no interest payment – loans obtained from friends and relatives – are even better than the loans that are granted from the formal sources. However, the loans obtained from such safe or harmless sources show a decreasing trend indicating a dying out of the transactions based on traditional or social relationships which were so far important in the rural economy.

4. Some moneylenders still charges very high interest rates even exceeding 100 percent per annum. Such adverse financial transactions should be arrested through with the interference of the Central Bank and other legal measures.

5. Easy access, freeing from collateral requirements and flexibility of terms and conditions are the most important characteristics of the informal credit that attract the borrowers. Since the informal sector moneylenders possess most of these characteristics, they still attract a substantial faction of peasants.

6. Cost of loans to borrowers of the institutional sources largely increases when a higher transaction cost is added to the interest payment. This is one main reason to deviate the borrowers from the institutional lending sources.

7. It seems that still there is no proper mechanism to keep all the financial institutions under the supervision of the Central Bank of Sri Lanka. Information about some of the institutions engaged in financial activities is not included in annual reports.

8. Although the same borrowers demand credit from both formal and informal sources, there is no any relationship between formal and informal lenders. Thus, there is a duality in the supply side of the formal financial market.

6.2 Policy Implications

The following are policy implications, which were derived from the results and conclusions of the study:

1. In order to expand the contribution of the formal sector in rural development, innovative strategies in mobilizing savings and financing the needs of peasants should be promoted in addition to the expansion of institutions in the rural sector. This is possible through learning the procedures of successful formal sector financial institutions and studying the strategies of the informal lenders.

2. Steps should be taken to get all institutions under the regulation and supervision of the Central Bank of Sri Lanka so that a substantial part of the informal activities would be converted into formal activities.

3. Peasants who borrow loans at very high interest rates from the informal sector should be educated about the available financial facilities and the benefits that they can have from the formal sector. Furthermore, since a very high percentage of people in the rural sector are not in a position to satisfy the collateral needs of the institutional moneylenders, granting loans on alternative and innovative saving mobilizing and funding strategies is an utmost need.

4. The duality in the supply side of the rural financial market should be eliminated by linking the informal lenders with the financial institutions. A proper link will eliminate the detrimental activities that the informal moneylenders impose on rural peasants.

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