Economics 172
Issues in African Economic Development

Professor Ted Miguel
Department of Economics
University of California, Berkeley
Economics 172
Issues in African Economic Development

Lecture 13 – February 27, 2007
What can public policy do about HIV/AIDS?

(1) Testing people, inform them of their HIV status
(2) Condom distribution
(3) Public health information campaigns (e.g., Uganda)
(4) Regulate prostitution
(5) Subsidize treatment for anti-retroviral medical treatment (ARVs). (Compliance and institutional capacity? Profits / smuggling?)

(6) Development of an HIV vaccine
What can public policy do about HIV/AIDS?

(1) Testing people, inform them of their HIV status
(2) Condom distribution
(3) Public health information campaigns (e.g., Uganda)
(4) Regulate prostitution
(5) Subsidize treatment for anti-retroviral medical treatment (ARVs). (Compliance and institutional capacity? Profits / smuggling?)

(6) Development of an HIV vaccine
(7) **Reduce transmission through circumcision**
What can public policy do about HIV/AIDS?

(1) Testing people, inform them of their HIV status
(2) Condom distribution
(3) Public health information campaigns (e.g., Uganda)
(4) Regulate prostitution
(5) Subsidize treatment for anti-retroviral medical treatment (ARVs). (Compliance and institutional capacity? Profits / smuggling?)

(6) Development of an HIV vaccine
(7) Reduce transmission through circumcision
(8) Others?
Key questions in the study of HIV/AIDS

(0) Measuring the extent of the problem (today)

(1) What impact does HIV/AIDS have on economic development in Africa?

(2) Why does HIV/AIDS continue to spread in Africa?

(3) What can / should public policy do about HIV/AIDS?
Outline:

(1) Udny (1990) on credit in Northern Nigeria
Formal banking in Sub-Saharan Africa

• Credit is critical for investment in profitable new business opportunities and for smoothing consumption
Formal banking in Sub-Saharan Africa

- Credit is critical for investment in profitable new business opportunities and for smoothing consumption

- But many banks in Africa have very high levels of non-performing loans (NPLs), cases where people are at least six months behind on payments. This threatens the solvency of the banking system
Formal banking in Sub-Saharan Africa

- Credit is critical for investment in profitable new business opportunities and for smoothing consumption.

- But many banks in Africa have very high levels of non-performing loans (NPLs), cases where people are at least six months behind on payments. This threatens the solvency of the banking system.

- For example, in the 1990s: Guinea-Bissau 45%, Kenya 20%, Madagascar 25%, Niger 50%, Senegal 50% (Kane and Rice 1999).
Formal banking in Sub-Saharan Africa

• Credit is critical for investment in profitable new business opportunities and for smoothing consumption

• But many banks in Africa have very high levels of non-performing loans (NPLs), cases where people are at least six months behind on payments. This threatens the solvency of the banking system

• For example, in the 1990s: Guinea-Bissau 45%, Kenya 20%, Madagascar 25%, Niger 50%, Senegal 50% (Kane and Rice 1999).

• Political corruption is a common explanation
Udry (1990) on credit in northern Nigeria

• An alternative to formal sector lending (from banks) is informal lending

• Options include loans among individuals, or group financial schemes (e.g., Rotating Credit and Saving Associations – ROSCAs, joint liability microfinance)
Udry (1990) on credit in northern Nigeria

- An alternative to formal sector lending (from banks) is informal lending.

- Options include loans among individuals, or group financial schemes (e.g., Rotating Credit and Saving Associations – ROSCAs, joint liability microfinance).

- Udry studies informal lending patterns in four villages in northern Nigeria. Most people in rural Nigeria (and in rural Africa more broadly) do not live close to any formal financial institution.
Credit in northern Nigeria

- 90% of households engaged in some borrowing or lending during 1988 (the study year)
- But only 7.5% of total credit received was from formal sources, either banks or firms (e.g., tobacco buyers)
Credit in northern Nigeria

• 90% of households engaged in some borrowing or lending during 1988 (the study year)

• But only 7.5% of total credit received was from formal sources, either banks or firms (e.g., tobacco buyers)

• These informal loans are large: on average individuals borrow the equivalent of 50 days of (average) wages per year, or 1000 Nigerian naira

• Most loans are made at the start of the planting season and are used for farm inputs (seed, fertilizer), and are paid back after the harvest)
Enforcing credit contracts

• Credit agreements are not legal contracts:
  “[T]hese deals are often extreme in their informality. They generally occur in private, with no witnesses and no written record. They are almost always made and repaid in cash.”
Enforcing credit contracts

• Credit agreements are not legal contracts:
  “[T]hese deals are often extreme in their informality. They generally occur in private, with no witnesses and no written record. They are almost always made and repaid in cash.”

• The repayment period and interest rate is typically not explicitly specified between the parties
Enforcing credit contracts

• Credit agreements are not legal contracts:
  “These deals are often extreme in their informality. They generally occur in private, with no witnesses and no written record. They are almost always made and repaid in cash.”

• The repayment period and interest rate is typically not explicitly specified between the parties

• Why do borrowers repay lenders in this setting? Why not just run off with the money?
Contracts in village economies

- Village settings are particularly favorable for informal contract enforcement:
Contracts in village economies

• Village settings are particularly favorable for informal contract enforcement:
  (1) Neighbors have good information about each other in a small, tight-knit community
Contracts in village economies

- Village settings are particularly favorable for informal contract enforcement:
  1. Neighbors have good **information** about each other in a small, tight-knit community
  2. People can appeal to **traditional authorities** (here, Muslim clerics) to adjudicate disputes. Those found to have cheated/ lied will be subject to **social sanctions / punishment** from the community
Contracts in village economies

- Village settings are particularly favorable for informal contract enforcement:
  1. Neighbors have good information about each other in a small, tight-knit community
  2. People can appeal to traditional authorities (here, Muslim clerics) to adjudicate disputes. Those found to have cheated/ lied will be subject to social sanctions / punishment from the community

- In a setting where people rely on others for loans, trade, labor assistance on their farm, friendship, etc., social sanctions by the community are very costly
Combined credit / insurance contracts

- Udry (1990) finds that informal credit deals are more sophisticated than bank transactions, especially at dealing with negative agricultural and health “shocks”:

  Koran 2:280: “And if the debtor is in difficulty, then there should be postponement to a time of ease.”
Combined credit / insurance contracts

- Udry (1990) finds that informal credit deals are more sophisticated than bank transactions:

<table>
<thead>
<tr>
<th></th>
<th>Monthly interest</th>
<th>Repayment period</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Borrower:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Negative shock</td>
<td>-4.0 percent</td>
<td>72 days</td>
</tr>
<tr>
<td>No shock</td>
<td>0.5 percent</td>
<td>67 days</td>
</tr>
<tr>
<td><strong>Lender:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Negative shock</td>
<td>2.6 percent</td>
<td>80 days</td>
</tr>
<tr>
<td>No shock</td>
<td>-7.5 percent</td>
<td>89 days</td>
</tr>
</tbody>
</table>
Combined credit / insurance contracts

- Udry (1990) finds that informal credit deals are more sophisticated than bank transactions:

<table>
<thead>
<tr>
<th></th>
<th>Monthly interest</th>
<th>Repayment period</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Borrower:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Negative shock</td>
<td>-4.0 percent</td>
<td>72 days</td>
</tr>
<tr>
<td>No shock</td>
<td>0.5 percent</td>
<td>67 days</td>
</tr>
</tbody>
</table>

|                     |                  |                  |
| **Lender:**         |                  |                  |
| Negative shock      | 2.6 percent      | 80 days          |
| No shock            | -7.5 percent     | 89 days          |
Combined credit / insurance contracts

- Udry (1990) finds that informal credit deals are more sophisticated than bank transactions:

<table>
<thead>
<tr>
<th></th>
<th>Monthly interest</th>
<th>Repayment period</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Borrower:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Negative shock</td>
<td>-4.0 percent</td>
<td>72 days</td>
</tr>
<tr>
<td>No shock</td>
<td>0.5 percent</td>
<td>67 days</td>
</tr>
<tr>
<td><strong>Lender:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Negative shock</td>
<td>2.6 percent</td>
<td>80 days</td>
</tr>
<tr>
<td>No shock</td>
<td>-7.5 percent</td>
<td>89 days</td>
</tr>
</tbody>
</table>
Challenges for the formal financial sector

- Banks suffer from several disadvantages relative to these informal lending networks

  (1) They may be located far away from the borrower
Challenges for the formal financial sector

• Banks suffer from several disadvantages relative to these informal lending networks

(1) They may be located far away from the borrower
(2) They thus have worse information than local informal lenders, and experience *moral hazard* (cheating)
Challenges for the formal financial sector

• Banks suffer from several disadvantages relative to these informal lending networks

(1) They may be located far away from the borrower
(2) They thus have worse information than local informal lenders, and experience *moral hazard* (cheating)
(3) With poor information about borrower circumstances, they cannot offer flexible credit / insurance contracts
Challenges for the formal financial sector

- Banks suffer from several disadvantages relative to these informal lending networks

1. They may be located far away from the borrower
2. They thus have worse information than local informal lenders, and experience *moral hazard* (cheating)
3. With poor information about borrower circumstances, they cannot offer flexible credit / insurance contracts
4. They cannot call upon local enforcement mechanisms or social sanctions for repayment – and formal legal channels (courts) may be slow and unreliable
• For next time: continue the Week 8 readings on “economic shocks and rural households”