Informal Finance: A Theory of Moneylenders

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Please note – only the abstract is available.
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Abstract

This paper argues that weak legal institutions explain the coexistence of formal and informal financial sectors in developing credit markets. Informal finance emerges as a response to the formal sector’s inability to perfectly enforce its legal claims. The theory shows that the two sectors can be either complements or substitutes and rationalizes credit market segmentation, where borrowers are restricted to the informal sector despite the existence of a formal alternative, as an outcome of market power in the formal financial sector. The theory sheds some light on the persistence of formal sector monopolies, the prevalence of informal finance, and the high effective interest rates observed in developing economies. The analysis also illustrates that promoting financial market competition may be a more efficient policy than improved creditor protection.

JEL classification: O12; O16; O17; D40.

Keywords: Credit markets; Institutions; Market structure.

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