

# How urban informal credit markets work in Bangladesh



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Informal credit is a non-institutional and unregulated way of extending credit to loan seekers, where money is lent by private individuals. Informal credit market plays a significant role in channelling funds mainly to poor borrowers both in rural and urban areas. A large number of people depend on informal credit markets since the formal credit system has some issues that may deter a section of people, especially the poor, from taking loans from it.

There are some compelling reasons for which informal credit markets prevail in an economy. In rural areas, formal financial institutions cannot reach all potential borrowers because of their faulty loan production technology. Rural borrowers have demand for small loans and providing them with service with costly bank branches

In Bangladesh, most of the microfinance institutions (MFIs) work in rural areas, targeting the poor and providing small loans without collateral. Hence, loan seekers have easy access to financial services. Formal financial institutions cannot serve the urban poor as there is a mismatch between demand and supply. In addition, the number of MFIs in urban areas is very low, although there is a high demand for small and collateral-free loans in urban areas too. Consequently, a large number of the urban poor depend mainly on informal credit markets to reduce their liquidity constraint.

There have been many studies on informal credit markets in rural Bangladesh. But the current understanding about urban informal credit markets is controlled

between July and October 2023 from 400 respondents who took informal loans. The respondents ranged from tea stall owners and rickshaw pullers, to hawkers, domestic helps, and others, considering that they come from the poor section of society. Of the respondents, 80 percent were male and 20 percent female. Meanwhile, 88 percent were married

and almost 11 percent from friends. The average size of the loan was Tk 25,580, with the range between Tk 2,000 and Tk 400,000. The most popular amount was found to be Tk 20,000. Nearly 54 percent loans had the value between Tk 5,001 and Tk 20,000, and 94 percent between Tk 2,000 and Tk 50,000. These findings suggest that informal lenders mainly

business, followed by 21 percent for treatment, 10 percent for purchasing goods like TV, refrigerator, etc, nine percent for weddings—ceremonies and dowry payment—and eight percent each for purchasing rickshaws/vans and repaying another loan. About 56 percent loans were taken for unproductive purposes. The result is quite normal

percent), accidental cost (29 percent), and lack of financial discipline (three percent). Borrowers failed to repay the loans mainly because of sluggish pace in business. Some borrowers (20 percent) diverted loans to non-productive uses such as consumption, medical treatment, household expenditure, which also led to loan default.

The most dominating consequence of loan default was harassment—verbal abuse, physical assault, threat in public, and others—by lenders (71 percent), followed by absconding (14 percent) and loss of collateral (11 percent). Sometimes, a lender sealed the house of a borrower to compel them to repay the loan.

About 51 percent of respondents borrowed from the informal credit market because they found it easy. Meanwhile, quick funding attracted 19 percent of borrowers, no collateral requirement induced 14 percent of borrowers. Less paperwork and the unavailability of formal credit encouraged seven percent and six percent, respectively.

As the study has shown, there are many practical reasons for which borrowers take loans from informal lenders. They don't need to make any periodic savings; rules and regulations are not rigid; there is also flexibility in loan size and the repayment of instalments; and at times, borrowers don't need to even mention their loans' purposes. This makes borrowing trouble-free. Moreover, informal loans are sometimes a matter of verbal agreement; borrowers don't need to produce paper documents and fill out an application form, and loan disbursement is done very quickly, often without collateral.

However, in the absence of regulations, informal credit markets are highly exploitative too. Therefore, banks, which are the main suppliers of formal finance in Bangladesh, must be proactive in reducing the scope of informal finance, because the sizeable presence of informal finance in an economy does indicate a big failure of the formal credit system.



VISUAL: SALMAN SAKIB SHAHRYAR

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is not profitable. Thus, many rural borrowers depend on the informal credit market. Similarly, a section of urban people also depends on informal credit markets because formal financial institutions fail to provide customised financial services to the poor through their complex service delivery system.

by a limited number of empirical studies. Until we know the state of urban informal credit markets, a major aspect of this sector will remain unexplored.

In 2023, I conducted a study on the situation of the urban informal credit market in Dhaka city. I used personal interviews to collect data

and the rest unmarried, divorced or abandoned. Rickshaw pullers (32 percent) were the largest group of borrowers, followed by hawkers (25 percent), tea stall owners (21 percent), and domestic helps (20 percent).

The study found that all respondents took loans from different sources in the previous 12 months. Among them, 24 percent took loans from moneylenders, 13 percent from local income groups, seven percent from *dadon* loan (a cash loan for crop production or product manufacturing, which is to be repaid in the form of produce, the price of which is predetermined, generally lower than the normal market price), and only five percent from goldsmiths. Twenty percent borrowers took loans from relatives, nearly 17 percent from neighbours,

provide small loans, but there is also demand for large loans from these lenders.

The study also found that the average interest rate was 24 percent, with the range between zero and 250 percent. Of the total loans, 75 percent had the interest rate less than or equal to 30 percent. Put it differently, 25 percent paid an interest of more than 30 percent. The prevalence of low interest rates is because 45 percent of borrowers took loans from their affluent relatives, well-off neighbours and generous friends at zero or minimum interest rates.

Informal loans were taken for both productive (income-generating) and unproductive (consumption) purposes. The highest demand for loan, about 36 percent, was for doing

because formal credit markets do not extend loans for such purposes.

Sixty-nine percent of the loans were granted without collateral. Those who were extended loans with collateral placed different types of collateral: third-party guarantee (48 percent), gold/silver (24 percent), mortgage/immovable asset (19 percent), and rickshaws/vans (nine percent). The informal credit market also requires collateral when the loan size is larger, and the borrower is new and perceived to be risky and has no third-party guarantee.

The trend of defaulted loans was found in the informal credit market as well. About 30 percent of the borrowers defaulted on loans. The main reason for that was high household expense (38 percent), followed by loss in business (30

# To tackle food inflation, we need long-term policies

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Since the onset of the Covid pandemic, inflation has remained one of the biggest challenges in Bangladesh's economy. According to the Bangladesh Bureau of Statistics (BBS), general inflation in December 2024 stood at 10.9 percent, a 0.5 percentage point decrease from 11.4 percent in the previous month. Food inflation in December 2024 was 12.9 percent, declining slightly by 0.9 percentage points from the previous month's rate. Tackling inflation, specifically food inflation, remains a major challenge for the interim government. Since inflation is a monetary phenomenon, i.e. determined by the supply, value, and circulation of money, the central bank is trying to take appropriate policy measures to control inflation. To this end, the Bangladesh Bank increased the repo rate (the interest rate at which the central bank lends to commercial banks) in October 2024 by 50 basis points to 10 percent, the fifth hike last year and 11th since May 2022.

Essentially, inflation occurs when aggregate demand exceeds aggregate supply, driving up prices. Excess demand is created mainly in two ways: firstly, when the demand increases with economic growth, known as demand-pull inflation. It is considered less severe than cost-pull inflation, which happens when the aggregate supply decreases due to a higher cost of production.

In the past five years, the world has faced two different economic shocks, both affecting aggregate supply adversely, i.e. cost-pull inflation: the Covid pandemic and the Russia-Ukraine war. The latter raised the cost of production in Bangladesh by increasing the price of fuel, decreasing

aggregate supply, and hence creating cost-push inflation. The pandemic also disrupted supply chains. This disruption, combined with the appreciation of the US dollar, worsened inflation by increasing the cost of imported raw materials. The official exchange rate of the US dollar was approximately Tk 85 in 2021, but as of

about 35 percent increase in six years. The increased consumption was reflected in both rural (34.8 grams to 46.1 grams) and urban (49.6 grams to 67.5 grams) areas. Economic growth has also been accompanied by population growth, which has also increased the demand for food. So, the inflation of necessary food

does so through a decrease in demand by tightening credit through increased interest rates, which affects the nutrition of the population negatively—potentially a damaging strategy in a country with a high prevalence of undernutrition. According to the World Health Organization (WHO), the stunting rate among under-five children in Bangladesh was 26.4 percent in 2022, significantly higher than the global average of 22.3 percent. Consequently, such a strategy may, in fact, increase inflation in the future by hurting human capital development and thus reducing long-run supply. Besides, higher interest rates may hurt investment and, consequently, supply, which can further worsen cost-push inflation in the long run.

Therefore, the demand-reducing measures are not long-term desirable policies. The government should focus on increasing supply in the long run to deal with inflationary pressure on essential commodities by increasing imports and domestic production. Proper incentives should be provided in these arenas to increase the supply of essential food commodities. Raw material prices in

poultry, livestock, and fishing should be controlled to ensure higher production, if necessary, through subsidy. Landless farmers can be provided with low interest loans to increase investment. The price of fuel could be subsidised as fuel is a substantial component of production costs. As short-run measures, safety net coverage should be increased so that all vulnerable households can afford basic necessities in the face of high inflation. These policies have, of course, implications for the national budget, but ensuring food security should be the top-most priority of the government. The tax-GDP ratio must be improved to finance these policies; currently, Bangladesh's tax-GDP ratio is one of the lowest not just in South Asia, but also in the world.

It is often argued that the market syndicates of essential commodities drive the prices up. If this is the case, then one would expect a large gap between production or import costs and retail prices. The government should scrutinise the market to verify the existence of syndicates and take measures accordingly.

The interim government has already taken some useful steps, such as withdrawing tariffs partially or fully on some essential commodities. In October 2024, the Trading Corporation of Bangladesh (TCB) launched a programme to sell oil, lentils, and rice from trucks in Dhaka and Chattogram, which was suspended recently. This programme should be resumed until inflation is under control to provide support to the underprivileged population. This will not only enable the vulnerable groups to buy food items at affordable prices, but also decrease market prices. The amount of public procurement of rice should be increased. The interim government should also procure other essential commodities like potatoes and onions, ensuring fair prices for farmers and eventually increasing the production of these products.



The Bangladesh Bank's current strategy to combat inflation by reducing demand may not help after all.

FILE PHOTO: RAJIB RATHAN

January 26, 2025, it has surged to Tk 122, marking a 41 percent increase. Moreover, the agricultural wage rate has been rising steadily, which contributes to food inflation. BBS data shows that between July 2023 and June 2024, the agricultural wage rate increased by 8.2 percent.

On the other hand, the country's economic growth has created excess demand at a steady rate. As a result, the demand for fish, meat, dairy products, and other commodities is increasing over time. According to the Household Income and Expenditure Survey (HIES), the national daily per capita consumption of meat, poultry, and eggs increased from 39 grams in 2016 to 52.8 grams in 2022,

items may occur due to both the demand-pull and cost-push phenomena.

Controlling cost-push inflation is inconceivably difficult. Some measures to prevent this type of inflation include freezing wages and putting a ceiling on the prices of basic commodities. However, these strategies are close to impossible to implement and not feasible for controlling inflation in the long run.

The central bank is currently trying to battle inflation by reducing demand, i.e. raising interest rates. But this strategy may not help in controlling essential commodity prices. Even when the contractionary monetary policy (higher rate reduces money supply) works, it

**The inflation of the necessary food items may occur due to both the demand-pull and cost push phenomena. Controlling cost-push inflation is inconceivably difficult. Some measures to prevent this type of inflation include freezing wages and putting a ceiling on the prices of basic commodities. However, these strategies are close to impossible to implement and not feasible for controlling inflation in the long run.**