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by

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List of Abbreviations

BC	Bank of Ceylon
CB	Central Bank of Sri Lanka (formerly Central Bank of Ceylon)
GDP	Gross Domestic Product
IMF	International Monetary Fund
PB	People's Bank
RB	Rural Bank (of the Multi-Purpose Co-operative Societies)
Rs	Rupees
SSM	Sarvodaya Shramadara Movement
TCCS	Thrift and Credit Co-operative Society

1 US-$ = 29.19 Rs (July 1987)

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Rural Financial Savings Mobilization in Sri Lanka: Bottlenecks and Reform Proposals

I. Introduction

A. Objectives and Overview

The objective of the following study is to evaluate rural deposit mobilization programmes in Sri Lanka, to identify major bottlenecks in the national savings system, and to provide recommendations for improving rural (financial) savings mobilization for financing rural development.

Major trends in aggregate and financial savings of the economy of Sri Lanka are given in the following section of the Introduction. Chapter II reviews the incentive system and institutional framework for (rural) deposit mobilization by focusing on interest rate policies, access to banking facilities, and the appropriateness of savings instruments. Rural financial savings by type of financial institution are examined in Chapter III. The scattered empirical evidence of the performance of informal savings (and credit) activities is elaborated in Chapter IV. In Chapter V, reform proposals for mobilizing rural savings for rural development are provided, based on an evaluation of major bottlenecks in savings mobilization (and credit supply) in rural areas. The discussion focuses on the preferential status of the National Savings Bank, the insufficient link between savings and lending activities, the problem of savings outflows from rural areas and policy options towards the informal (financial) sector.

B. Trends in Aggregate and Financial Savings

Domestic savings as a percentage of GDP have fluctuated in Sri Lanka between 14 and 22 per cent in the period 1977-1985 (Table 1). The average savings ratio for this period is higher than that of many other countries in a similar stage of development. However, when referring to the ambitious investment effort which has been undertaken in the last ten years, and to the binding constraint of receiving foreign (commercial) credit as a consequence of the debt crisis, the savings performance in the eighties was rather moderate. The strong variations in the savings to GDP ratio highlight the dependency of the Sri Lankan economy on the external sector. The evolution of the marginal propensity to save has more or less followed trends in the terms of trade (Table 1). In general, a change in the terms of trade in favour of Sri Lanka has tended to raise the savings to GDP ratio, and vice versa[1].

Financial savings[2] have grown between 1975 and 1985 every year, except for 1981 and 1985; the average rate of growth for this period was 15 per cent, which is substantially in excess of (nominal) GDP growth (Table 1). The year-to-year fluctuations in financial savings can largely be explained by changes in real and nominal interest rates, and by net private capital inflows and transfers, particularly foreign remittances. The interest rate sensitivity is especially valid for changes in the holdings of money and quasi- money, while providence and life insurance funds have shown a more stable tendency. The influence of shifts in net private capital inflows and transfers from abroad points to the importance of the openness of the economy, and the relatively large Sri Lankan labour force abroad to any strategy of savings mobilization in the country.

The performance of financial savings was sustained by the size, extensive geographical coverage, and institutional sophistication of the financial system. The geographical coverage of deposit-taking institutions, including post offices and rural banks, is

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[1] One explanation for this behaviour could be that disposable income rises and falls with changes in the terms of trade.

[2] Defined as the change in broad money (money plus quasi-money) and other liabilities of banks and non-banks to the private sector.

Table 1 - Trends in Aggregate and Financial Savings and other Macro-Economic Indicators, Sri Lanka 1978 -1985

	1978	1979	1980	1981	1982	1983	1984	1985
	(in per cent of GDP)							
Domestic Savings	15.5	14.7	14.0	14.0	15.4	16.4	21.6	15.3
Foreign Savings	4.5	11.1	19.8	13.8	15.2	12.4	4.2	9.6
Total	20.0	25.8	33.8	27.8	30.6	28.8	25.8	24.9
	(percentage change)							
Broad Money	29.6	40.6	28.9	17.9	29.6	24.2	18.8	12.8
Money	10.5	29.7	22.1	6.6	17.3	25.0	14.1	12.1
Quasi-Money	46.0	47.7	32.8	23.9	35.2	23.8	20.7	13.0
Actuarial Reserves and Members' Balances	24.4	23.4	21.7	22.5	22.9	24.6	25.8	24.3
Total (Financial Savings)[a]	...	35.8	-19.7	-32.0	52.6	-9.9	-17.9	-16.4
Nominal GDP	17.2	22.8	27.0	27.8	17.8	21.8	25.4	6.8
	(in per cent)							
Real GDP	8.2	6.3	5.8	5.8	5.1	5.0	5.0	5.0
Inflation Rate[b]	12.2	10.8	26.1	18.0	10.8	14.0	16.6	(1.4)
Terms of Trade	-3.8	-7.5	-11.8	-7.0	-3.0	18.0	19.2	-14.9
Interest Rates[c]	(%)							
Nominal Rates:								
- Commercial Banks (minimum rate)	14.0	14.0	20.0	20.0	15.0	16.0	14.0	12.0
- National Savings Bank	15.0	15.0	20.0	20.0	20.0	20.0	18.0	15.0
Real Rates:								
- Commercial Banks (minimum rate)	1.8	3.2	-6.1	2.0	4.2	2.0	-2.6	(10.6)
- National Savings Banks	2.8	4.2	-6.1	2.0	9.2	6.0	1.4	(13.6)
	(in per cent of GDP)							
Private Capital Inflows and Transfers (net)[d]	1.3	4.3	10.0	7.7	11.6	9.1	4.8	5.2

[a]Defined as change in broad money (money plus quasi-money) and actuarial reserves and members' balances. - [b](Average) cost of living index. - [c]On one-year deposits. - [d]Including net capital inflows of State Corporations and net errors and omissions.

Source: Central Bank of Sri Lanka, Annual Report 1986, Colombo 1987, IMF estimates; own calculations.

extensive. Maturities of bank deposits amount up to 12-month time deposits. A broad range of instruments, including certificates of deposits and debentures has evolved, while equity financing has remained relatively unimportant[1].

While the commercial banks are by far the largest holders of financial savings, their share of total financial savings has been steadily eroded from 57 per cent of total financial savings in 1978 to 34 per cent in 1985 (see Table 2). The second most important holder of financial savings is the Employee Fund, whose share has increased from 17 per cent in 1978 to 27 per cent in 1985[2]. The National Savings Bank (NSB) is the most important single-deposit institution keeping a share of 16 per cent in total savings in 1985, which was also the average share of financial savings in the period 1978-85, although this share has fluctuated between 8 per cent (1981) and 22 per cent (1982)[3]. From the remaining financial institutions (the Foreign Currency Bank Units, insurance companies and finance companies), only the finance companies have increased their share of financial savings, while the behaviour of the other institutions has fluctuated considerably. The co-operative sector accounted for the balance with less than one per cent. In this category, the share of (Co-operative) Rural Banks is by far the most important, while the contribution of co-operative credit societies to the total volume of financial savings is negligible.

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1 At least there are no data that would permit an assessment of the performance of equities as a form of financial savings.

2 This increase is explained, in part, by the gradual integration of an increasing percentage of the work force into the Employee Fund.

3 The sudden gain in market share in 1982 is explained by a reduction by commercial banks of their minimum rates on 12-month fixed deposits from 20% to 15%, while the corresponding rate of the NSB remained at 20%.

Table 2 - Financial Savings by Type of Institution[a], Sri Lanka 1978-1985

Institution	1978	1979	1980	1981	1982	1983	1984	1985
	(percentage distribution)							
Central Bank	7.4	10.3	7.2	9.9	12.6	10.5	10.9	16.5
Commercial Banks[b]	57.1	60.4	62.4	58.0	46.4	52.3	40.6	37.0
Finance Companies	-	-	5.7	2.4	4.2	3.1	8.3	n.a.
National Savings Bank	16.9	16.0	9.7	8.0	21.7	16.0	17.1	16.0
Employees Fund[c]	16.3	11.5	13.2	19.6	14.2	17.4	21.7	30.5
Insurance Companies	2.3	1.8	1.8	2.1	0.9	0.7	1.4	n.a.
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

[a]Defined as change in broad money (money plus quasi-money), plus change in actuarial services, plus members' balances. - [b]Inclusive deposits in Foreign Currency Banking Units. - [c]Includes Employees Provident Fund and Employees Trust Funds. - n.a. = not available.

Source: Data provided by the Central Bank of Sri Lanka; own calculations.

II. Incentive System and Institutional Framework for (Rural) Deposit Mobilization

A. Interest Rate Policies

Available data seem to indicate that in Sri Lanka, as in many other Asian countries (see Corsepius, Fischer, 1986), it is easier to find supporting evidence showing a link between interest rates and (the level and composition of) financial savings than between interest rates and total domestic savings[1]. Real interest rates on savings and fixed-term deposits, estimated as nominal rates minus inflation, varied considerably between 1970 and 1986 (Table 3), which was mainly the result of volatile inflation rates and an inflexible adjustment of nominal interest rates. While the real (minimum) interest rate for savings accounts has been negative since 1978 (with the exception of 1985), fixed-term deposits tended to yield higher returns in real terms. Although interest rate policies have been more flexible since 1977 than in earlier years, especially interest rates for savings accounts have proved to be quite rigid (for example, the minimum rate was kept constant at the 10% level throughout the period 1980-85). Beyond that, there seems to be no economic rationale for the large differential between minimum and maximum rates for the different types of deposits.

The prevailing range of interest rates on the deposit-taking institutions has largely been influenced by the authorities, i.e. through the Bank and Treasury bill rates set by the Central Bank, as well as through interest rates applied by the National Savings Bank (NSB). NSB's deposit rates are insulated from market forces as the government covers the difference between its costs to mobilize funds and the yield on the asset, which are mainly invested in government securities. The partial tax-exemption status of interest on NSB deposits introduced an additional competitive

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[1] Besides the direct impact on the real return of domestic savings, interest rate movements also appear to have had an effect on net private capital inflows and transfers, which in turn have affected private savings.

Table 3 - Nominal and Real Interest Rates by Type of Deposit, Sri Lanka 1970-1985

Year	Nominal Interest Rate (%)								Inflation Rate[a]	Real Interest Rate[b] (%)							
	Savings		Fixed Term Deposit							Savings		Fixed Term Deposits					
			3 months		6 months		12 months		percent-age change			3 months		6 months		12 months	
	Max.	Min.	Max.	Min.	Max.	Min.	Max.	Min.		Max.	Min.	Max.	Min.	Max.	Min.	Max.	Min.
1970	4.5	4.5	4.75	4.5	4.75	4.5	4.75	4.5	5.9	-1.4	-1.4	-1.15	-1.4	-1.15	-1.4	-1.15	-1.4
1971	4.5	4.5	4.75	4.5	4.75	4.5	4.75	4.5	2.7	1.5	1.8	2.05	1.8	2.05	1.8	2.05	1.8
1972	4.5	4.5	4.75	4.5	4.75	4.5	4.75	4.5	6.3	-1.8	-1.8	-1.55	-1.8	-1.55	-1.8	-1.55	-1.8
1973	4.5	4.5	4.75	4.5	4.75	4.5	4.75	4.5	9.7	-5.2	-5.2	-4.95	-5.2	-4.95	-5.2	-4.95	-5.2
1974	4.5	4.5	4.75	4.5	4.75	4.5	4.75	4.5	12.3	-7.8	-7.8	-7.55	-7.8	-7.55	-7.8	-7.55	-7.8
1975	5.5	5.5	6.75	6.0	7.0	6.5	7.5	7.0	6.7	-1.2	-1.2	0.05	-0.7	0.3	-0.2	0.8	0.2
1976	5.5	5.5	6.75	6.0	7.0	6.5	7.5	7.0	1.2	4.3	4.3	5.55	4.8	5.8	5.3	6.3	5.8
1977	7.2	7.2	8.5	8.5	12.0	11.0	15.0	14.0	1.3	5.9	5.9	7.2	7.2	10.7	9.7	13.7	12.7
1978	7.2	7.2	8.5	8.5	12.0	11.0	15.0	14.0	12.1	-4.9	-4.9	-3.6	-3.6	-0.1	-1.1	2.9	1.9
1979	9.0	7.2	8.5	8.5	12.0	11.0	15.0	14.0	10.8	-1.8	-3.6	-2.3	-2.3	1.2	0.2	4.2	3.2
1980	14.0	10.0	16.0	12.0	18.0	15.0	20.0	20.0	26.1	-12.1	-16.1	-10.1	-14.1	-8.1	-11.1	-6.1	-6.1
1981	14.0	10.0	20.0	12.0	21.5	15.0	22.0	20.0	18.0	-4.0	-8.0	2.0	-6.0	3.5	-3.0	4.0	2.0
1982	14.5	10.0	17.0	10.0	15.5	12.0	22.0	15.0	10.8	3.7	-0.8	6.2	-0.8	7.7	1.2	11.2	4.2
1983	15.0	10.0	22.0	10.0	25.0	13.0	25.0	16.0	14.0	0.5	-4.0	1.0	-4.0	8.0	-4.0	11.0	-1.0
1984	15.0	10.0	19.0	10.0	19.0	13.0	22.0	14.0	16.7	-1.7	-6.7	-1.7	-6.7	2.3	6.7	2.3	-1.0
1985	13.5	10.0	17.0	9.0	19.0	9.0	18.0	12.0	1.5	12.0	8.5	15.5	7.5	17.5	7.5	16.5	10.5
1986[c]	12.0	6.0	12.0	8.0	12.5	8.5	13.5	8.5	8.0	4.0	-2.0	4.0	0.0	4.5	0.5	5.5	0.5

[a]Annual percentage change of the consumer price index. - [b]Real interest rate calculated as nominal interest rate minus inflation Rate. - [c]As at August 31, 1986.

Source: Data provided by the Central Bank of Sri Lanka; IMF estimates; own calculations.

edge for this institution. The slow response of NSB to market trends created not only substantial financial transfers to and from other institutions, but also resulted in market instability of monetary conditions as the money multipler is likely to vary, depending on which institutions are gaining resources and which are losing them. This is the case because reserve requirements (at present 16 per cent for demand and 8 per cent for time and savings deposits) only apply to commercial banks. Since reserve requirements can only be met in the form of non-interest-bearing deposits in the Central Bank, this implies an additional transfer of resources to the Central Bank that increases the cost of intermediation.

Notwithstanding the above-mentioned shortcomings, the liberalization policies initiated in 1977 have freed up interest rates and resulted in a trend towards positive real rates of interest on savings deposits. This was an important stimulus for financial savings to increase. However, a serious distortion still exists on lending rates for agricultural credit, which continued to reveal negative interest rates in real terms in the last ten years (Table A1), as a consequence of the subsidies involved in various refinance schemes from the Central Bank. This reliance on refinanced funds has undoubtedly hindered the development of self-sustaining and viable rural financial institutions and markets in Sri Lanka.

B. Access to Banking Facilities

The access to banking facilities in rural areas has improved substantially in the last 15 years (Table 4)[1]. The number of branches of commercial banks operating in rural areas increased from 122 (1970) to 571 (1986). This expansion was strengthened mainly through the People's Bank and the Bank of Ceylon, both

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[1] Rural areas are for the present purpose defined somewhat crudely as the entire country, except the city of Colombo and the suburbs.

Table 4 - Number and Distribution of Financial Institutions by Rural and Urban Areas, Sri Lanka 1970-1985

Year	Rural Areas				Urban Areas			Total
	Commercial Banks[a]	Rural Banks	Credit Coope-ratives/Unions	Total	Commercial Banks	Other Institutions[b]	Total	
1970	122	90	1,670	1,882	40	265	305	2,187
1971	146	111	1,670	1,927				
1972	159	245	1,407	1,811				
1973	173	341	1,179	1,693				
1974	202	403	2,711[c]	3,316				
1975	203	447	2,541[c]	3,191	59	320	379	3,570
1976	233	503	2,445[c]	3,181	67	331	398	3,579
1977	258	544	n.a.	(802)	71	n.a.	(71)	(873)
1978	278	558	935	1,771	76	270	346	2,117
1979	341	586	910	1,837	79	371	450	2,287
1980	395	641	944	1,980	87	371	458	2,438
1981	448	746	1,094	2,288	96	396	492	2,780
1982	475	804	1,195	2,474	110	375	485	2,959
1983	577	843	1,213	2,633	789	n.a.	n.a.	n.a.
1984	545	888	1,758[d]	3,191	90	n.a.	n.a.	n.a.
1985	542	902	2,216[d]	3,660	90	n.a.	n.a.	n.a.
1986	571	924	4,559[e]	6,054	99	n.a.	n.a.	n.a.

[a]Branches of Bank of Ceylon, People's Bank and Hattan National Bank excluding the branches in Colombo. - [b]Co-operative Credit Societies of Limited Liability. - [c]Inclusive inactive credit societies. - [d]Including limited and unlimited credit societies. - [e]Rural credit societies.

Source: Data provided by the Central Bank of Sri Lanka; Silva (no date, Tables 2.1. and 2.2.); own calculations.

State-owned. Over the same period, the number of (co-operative) rural banks - established by the People's Bank in 1961 and managed by multipurpose co-operative societies - increased from 90 to 924. In addition to these two categories of institutions there are in Sri Lanka a fairly large number of credit co-operatives, some of which enjoy a limited liability status[1].

When both commercial banks and rural banks are taken together, the number of population per office was about 8,600 in 1982 (against 5,000 in the city of Colombo, or 1,000, if private finance companies are added). If compared internationally, the institutional penetration of rural areas is well above the average of countries of a similar stage of development (Fischer et al., 1986, Table 16).

However, these averages might be somewhat distorted, since most of the "rural" branches are concentrated in semi-urban areas and larger villages. Nevertheless, there seems to be no need for expanding the network of branches in face of the weak intermediation performance of rural financial institutions in the last few years.

C. Appropriateness of Savings Instruments

There is a wide range of savings instruments offered by financial institutions in Sri Lanka[2]. However, most of the voluntary and non-contractual financial savings consist of savings and time deposits (Table 5). Although other types of deposits, such as savings certificates and premium savings bonds, have only played a minor role, banks and savings institutions have also strongly competed among themselves to offer new, attractive savings instruments with additional or fringe benefits. Both state sector banks have offered several contractual forms of savings, aimed at

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[1] These primary societies are based on the German Raiffeisen model and may therefore be considered as genuine co-operatives.

[2] For recent trends in the savings deposits markets see Weerasinghe (1987).

Table 5 - Financial Savings by Type of Deposit[a], Sri Lanka 1978-1985

Type of Deposits	1978	1979	1980	1981	1982	1983	1984	1985
	(percentage distribution)							
Currency (outside banks)	5.3	10.8	5.7	10.3	10.4	9.9	10.8	11.1
Demand deposits	8.0	14.2	17.9	-0.4	5.0	13.9	5.5	6.7
Savings deposits	7.6	9.3	4.5	11.8	16.3	8.8	15.3	21.1
Time deposits	46.6	40.6	58.2	61.6	48.9	48.7	43.1	26.2
Other deposits[b]	13.8	11.8	-1.3	-5.0	4.3	0.5	2.2	4.2
Actual resources and members's balances[c]	18.7	13.3	15.0	21.7	15.1	18.2	23.1	30.7
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

[a]Defined as change in broad money (money plus quasi-money), plus change in actuarial services, plus members' balances. - [b]Inclusive import deposits and GIS suspense account with Commercial Banks and savings certificates, premium savings bonds, pension scheme and interest due on deposits with National Savings Bank. - [c]Includes balances and funds of Employees Provident Fund, Employees Trust Fund, and Life Insurance Fund.

Source: Data provided by the Central Bank of Sri Lanka; own calculations.

persuading depositors to invest in long-term deposits for periods of 15 to 20 years. The Pension Scheme is one such scheme which seeks to induce depositors to invest small sums of money over a specified period of time in the hope of receiving a stream of benefits upon reaching the age of retirement. Another scheme which both banks have marketed with good success is the Minors Endowment Scheme. Under this scheme parents were encouraged to invest a lump sum which would remain with the bank until the child reaches 21 years of age, at which time the deposit would be paid together with accumulated interest. The People's Bank and the National Savings Bank have experimented with variants of the premium scheme, under which cash prices are offered to winners. Banks have also been allowed by the government to offer Sri Lankans working abroad a new facility - Non-Resident Foreign Currency Account - in which remittances can be held in foreign currency earning interest in foreign currency for a period of ten years, during which period the depositor enjoys the right to use these funds without being subject to exchange controls.

Transaction costs related to opening new accounts and making deposits and withdrawals can be assessed to be relatively low, even for small savers. For example, the minimum amount required for the opening of a savings account is as low as Rs 5-10, depending on the type of financial institution. At the same time, banks have attempted to simplify their procedures related to opening and withdrawal of accounts, started the practice of automatic removal upon maturity, and of paying monthly, quarterly, or half-yearly interests.

III. (Rural) Financial Savings by Type of Institution

A. Commercial Banks and Financial Companies

At present there are 22 foreign banks and four indigenous banks operating in Sri Lanka. The two state banks, namely the People's Bank and the Bank of Ceylon, account for approximately 90 per cent of the banking business of the indigenous banks, whilst the two small private banks (Hatton National Bank and the Commercial Bank) together account for approximately 10 per cent of banking activities of the indigenous banks. Commercial banks have functioned as the most important vehicles for deposit mobilization, accounting for 37 per cent of total financial savings in 1985 (Table 2). The predominance of the commercial banking sector in deposit mobilization is understandable, as the banks, through their wide network of branches all over the country, provide access to the saver as a convenient and safe outlet for savings. An additional factor may be that the foreign remittances, especially from the Middle East countries, which have become a significant source of savings and which, because remittances come through commercial banks, tend to remain within the commercial banking sector. The finance companies, which mainly operate in Colombo and a few provincial towns, could increase their relative shares in the last few years substantially (1984: 8.3 per cent).

The progress of rural savings mobilization cannot be traced easily, as disaggregate data for the commercial banking sector, showing the volume of deposits mobilized in rural areas, are not available. However, both the Bank of Ceylon and the People's Bank (together with the affiliated Rural Banks - see section C.1. -) have a widespread network of branches in rural areas, and obviously have been quite successful in mobilizing rural deposits (Fernando, 1986a), while private domestic banks and finance companies have played a minor role, due to the concentration of their branches in Colombo[1]. Given the poor lending performance of

[1] Worthmentioning is, however, a mobile bank savings scheme initiated as a pilot project by the Hattan National Bank, which was designed to tap the savings of tea plantation workers, a segment of the Sri Lankan population hitherto neglected by the banking sector as being to poor to save. For an examination of this experience see Silva, Gnanasekeram, 1985.

commercial banks in rural areas, one can safely assume that the vast majority of savings mobilized in rural areas has been diverted out of the rural economy to urban and export-oriented investment.

B. National Savings Bank

The National Savings Bank (NSB), founded in 1972, is a specialized savings institution having absorbed, since its foundation in 1972, the functions of the Post Office Savings. It has been very successful in attracting savings in urban and rural areas due to its large numbers of service outlets (number of branches, post office and sub-post offices in 1986: 60, 478 and 3,220 respectively), its offering slightly better interest rates than commercial banks, which usually follow the NSB in order to maintain market share, and a wide range of savings instruments[1]. Up to 1985, the NSB also enjoyed a special tax concession for depositors not available from the commercial banks[2]. In 1986, the NSB could substantially increase its market share in the banking sector from 28 per cent (1985) to 47 per cent (Central Bank of Sri Lanka, 1987, Table 47). despite a reduction of interest rates on deposits and the introduction of a withholding tax on interest rates earned on deposits.

Between 1975 and 1986, there was a clear trend of increasing importance of fixed deposits (from 13.9 per cent to 68.7 per cent of total balances), whereas the percentage share of ordinary savings accounts on total deposits declined from 78.6 per cent to 29.1 per cent in the same period, reflecting mainly the change of

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1 Including pension schemes, endowment schemes and premium savings bonds. Among the additional measures taken to mobilise savings are mobile banking services, authorised savings representatives, and special savings schemes for the plantation sector (National Savings Bank, 1986, pp. 2-3).

2 Interest earnings up to Rs 2,000 per person (maximum four persons per family), <u>or</u> one-third of all interest income, whichever is greater, is exempt from income tax.

Table 6 - Deposit and Loan Profile of the National Savings Bank, Sri Lanka 1975-1986

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
						(1000)						
Number of Accounts	5,742	5,524	6,265	6,555	6,852	7,114	7,288	7,520	7,757	7,958	8,117	8,237
						(Rs)						
Average Amount of Deposits per Account	246	304	276	516	657	730	780	1,078	1,298	1,534	1,736	1,803
Balances						(percentage distribution)						
- Ordinary Savings	75.6	78.5	64.8	54.5	45.1	41.3	39.6	30.8	28.7	26.4	26.3	29.1
- Fixed Deposits	13.9	14.8	30.7	43.0	52.9	57.3	59.3	67.8	69.7	71.8	71.7	68.7
- Savings Certificates[a]	7.5	6.7	4.5	3.0	2.0	1.4	1.1	0.5	0.2	0.1	0.1	0.1
- Other Savings Schemes[b]	-	-	-	-	0.0	0.0	0.0	0.9	1.4	1.6	1.9	2.1
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Investment and Loans						(percentage distribution)						
- Government Securities	96.2	96.0	91.7	83.4	87.5	93.3	90.0	91.9	91.4	80.8	90.7	91.9
- Housing Loans	2.0	1.9	1.8	1.8	1.4	1.4	1.5	1.3	1.2	1.2	1.2	1.2
- Other Investments[c]	1.8	2.1	7.5	14.9	11.1	5.3	8.5	7.8	7.7	18.0	8.1	6.9
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Number of Branches	20	22	25	27	36	42	45	47	50	52	57	60
Number of Post Offices	323	324	333	345	364	404	421	438	446	454	473	487
Number of Sub Post Offices	2,473	2,528	2,575	2,654	2,886	2,937	3,993	3,145	3,162	3,178	3,200	3,220

[a]Including gift tokens - [b]P.M.I.P. & Pension Scheme, Endowment Scheme, and Premium Savings Bonds. - [c]Including Treasury Bills and Sterling associated newspapers.

Source: Data provided by National Savings Bank; own calculations.

interest rate structure in favour of fixed deposits (Table 6). Savings certificates and other savings schemes only played a minor role. The average account of deposits increased from Rs 246 (1975) to Rs 1,803 (1986). At the end of 1983, most of the savings accounts were with deposits below Rs 10,000 (Table A2). Since the bulk of deposits (over 90 per cent) is greatly invested in government securities and treasury bills, the funds mobilized in rural areas are not lent there but designed to finance government budgetary requirements.

C. Co-operative Movement

1. (Co-operative) Rural Banks

In 1964, some of the larger, more successful Milti-Purpose Cooperative Societies (MPCSs) formed - with the assistance of the People's Bank - a self-administered savings and loan facility[1]. Fostered by the Co-operative Department, these institutions expanded very rapidly, covering 283 Rural Banks with 646 branches in 1986 (Table 7). At the same time, deposit mobilization in rural areas increased from Rs 16.9 million (1979) to Rs 1,259.1 million (1986) (Table 8).

Since Rural Banks are not recognized as "banks" by the Central Bank and the Monetary Law, they are forbidden from accepting demand deposits or operating checking accounts. They are also exempted from legal reserve requirements, which gives them a competitive edge on commercial banks. All Rural Banks are required to make a monthly deposit to a Deposit Guarantee Fund administered by the People's Bank. The amount is 0.1 per cent (per month) of the total deposits in fixed and savings accounts.

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[1] Assistance was provided by the People's Bank in granting loans and in providing training and technical assistance through a specially trained advisor attached to each Rural Bank. For details see Gunasekara (1986). The evolution of Rural Banks in Sri Lanka is analysed by People's Bank (1983).

Table 7 - Number of Branches, Deposits Mobilized and Lending Operations of (Co-operative) Rural Banks, Sri Lanka 1967-1986

Year	Number of Banks		Deposits[a] (million of Rs)	Advances		Total Advances as per cent of Deposits
	Rural Banks	Branches		Pawning (million of Rs)	Loans (million of Rs)	
1967	27	-	1.4	0.6	2.0	194.2
1970	90	-	16.9	2.0	7.1	53.8
1975	338	109	74.2	49.9	37.4	117.6
1980	284	357	334.7	97.1	79.7	48.0
1981	287	459	434.1	170.7	100.9	62.6
1982	286	518	541.5	206.8	122.5	60.8
1983	288	555	718.0	243.9	147.7	54.5
1984	286	602	905.5	323.1	185.2	56.1
1985	286	628	1,087.5	340.7	234.1	52.9
1986[a]	283	646	1,259.1	366.7	272.5	49.4

[a]Position as at September 30, 1986.

Source: Data provided by People's Bank; own calculations.

Table 8 - Savings and Fixed Deposits with (Co-operative) Rural Banks, Sri Lanka 1977-1986

Year	Savings Accounts		Savings per Account Holder (Rs)	Fixed Deposit Accounts		Amount per Account Holder (Rs)
	Number (1000)	Amount (million of Rs)		Number (1000)	Amount (million of Rs)	
1977	803.5	170.5	212	2.4	4.9	2,048
1980	1,160.3	309.2	266	9.2	59.2	6,449
1981	1,327.3	359.8	271	18.1	77.2	4,276
1982	1,464.2	442.0	302	23.6	99.5	4,221
1983	1,612.5	589.8	365	24.8	128.2	5,176
1984	1,773.7	752.1	424	28.3	153.4	5,418
1985	1,939.0	927.1	478	24.7	160.5	6.497
1986[a]	2,031.4	1,080.5	532	25.0	178.6	7,159

[a]Position as at September 30, 1986.

Source: Data provided by People's Bank; own calculations.

The main strength of Rural Banks seems to be savings mobilization. Statistically, one out of eight inhabitant of Sri Lanka had a savings account with a Rural Bank in 1986. Although interest rates paid on ordinary savings and deposits are slightly lower than those of commercial banks, the accessibility of the Rural Banks has obviously more than compensated for this relative disadvantage. The bulk of deposits mobilized from members and non-members are savings deposits; the number of savings accounts nearly doubled between 1980 and 1986 up to two million. Average savings per account holder were Rs 532 in 1986, indicating that most of the funds come from middle-income savings units. Fixed-term deposits accounted for less than 15 per cent of total deposits, and the much higher average amount per account holder (1986: Rs 7,156) demonstrates that these funds stem from the wealthier part of the rural population.

The advances of Rural Banks are loans to co-operative societies and pawning. For loans up to Rs 5,000, two guarantors are usually accepted as security, while larger loans require collatoral (for example, land titles). Loans are also available against 90 per cent of fixed and savings balances, although lending based on this form of security seems to be rather an exception. The dominant (and more profitable) lending business is pawnbroking (Table 8), whereby members and non-members can obtain loans against pawned jewellery. Lending activities have risen only moderately over the last few years, and could not be expanded in line with the extension of bank branches and savings accounts. Since 1980, the share of total advances to total deposits was below 60 per cent. Excess funds are either deposited with the People's Bank or, more recently, with the National Savings Bank. Because of the poor lending performance of the People's Bank in rural areas (and the fact that most of the deposits of the NSB are used to finance government expenditure), the primary beneficiaries of RB's mobilized deposits are import and export financing, industry and trade activities, typically located in urban areas.

2. Thrift and Credit Co-operative Societies (TCCSs)

Since 1979, the Department of Co-operative Development has been making efforts to revive TCCSs, which seemed to be promising institutions for rural credit and savings development in Sri Lanka. The most important reform elements introduced since 1979 are: the conversion of some successfully-run societies into co-operative banks; the granting of limited liability status to these societies (which gives them more autonomy in deciding policies pertaining to lending and deposit mobilization); maintenance of an office at a specific address with regular office hours for acceptance of deposits and making payments; the appointment of a paid, full-time manager to carry out office functions and maintain account books; and finally, the establishment of District Unions of TCCSs to function as coordinating agencies. Table 9 shows that there have been 1,700 TCCSs with around 229,000 members in 1983, spread throughout the country. Growth in deposits has been significant between 1976 and 1981, but has slowed down in the following years.

The organizational principle of these societies is as follows: Either the villagers themselves or an outside organizer brings together a group of people who wish to make savings deposits, which will form a lending base. While previously self-sufficiency of these societies was implicit since village savings were the only funds which could be lent, more recently their federation and some District Unions have changed their original rationale substantially. This was mainly due to the injection of external funds from Government and foreign donors at subsidized rates, which eroded financial discipline and the formerly attached importance to the volume of savings in determining the extent of borrowings that a member could seek from a society.

While all TCCSs offer a standard savings account, some of them also offer fixed deposits, childrens' accounts, and/or group accounts. Regular monthly deposits are urged on members and non-members alike. Typically, the TCCSs pay interests on savings with

Table 9 - Characteristics of the Thrift and Credit Co-operative Societies, Sri Lanka 1976-1983

Year	Number of Societies	Membership (1000)	Deposits (Million Rs)	Lendings (Million Rs)
1976	2,961	276,4	34.2	54.8
1977	1,407	204.7	37.0	50.4
1978	1,298	232.3	55.5	54.6
1979	1,278	202.7	71.6	47.1
1980	1,271	198.7	77.1	74.3
1981	1,507	215.2	103.5	120.4
1982	1,430	169.2	97.4	129.9
1983	1,685	220.7	113.2	139.1

Source: Data provided by the Department of Co-operative Development; own calculations.

a rate of one to two percentage points higher than those offered by the banks, depending on the type of account. Unless arrangements have been made to deposit excess cash in a TCCS's District Bank, the societies maintain an account with a commercial bank.

The loans committee accepts applications from potential borrowers who, unlike depositors, must be shareholders. Decisions on loans and subsequent supervision are discussed in the general meetings which are held monthly. Loan sizes are generally small, depending on the TCCS's capital fund, demand for loans, and intended end-use. In newer societies, or those with low capital funds, loans of Rs 500-1000 are common, while established TCCSs make loans of up to Rs 5,000 and more. Interest rates for most loans of the TCCS's own funds have been around 14-16% in 1986, and hence well above the concessional loan rates of 6% and 9% of the Million Houses Programme and the New Comprehensive Rural Credit Scheme, credit programmes which have tried to be channelled through the TCCSs.

A case study of three TCCSs in Kegalle District provides an interesting insight with regard to the savings behaviour of TCCS members (Attanayake, 1985). As one would expect, the average amount of savings deposited is closely related to income, although even those receiving food stamps had savings with the TCCSs. Higher interest rates have in general attracted more term deposits (fixed deposits and investment savings), and have had an especially significant bearing on the volume of non-member deposits. Even more interesting are the factors which proved to be particularly relevant for savings mobilization by TCCSs. The most important factor that motivated the villagers in joining the society and to save with it was the easy access to credit (especially in cases of emergency). Intimate knowledge of each other, lack of security conditions, and the simple method of processing loan applications have enabled TCCSs to perform their credit functions to the satisfaction of the members. A further important factor was seen in the close proximity of the TCCSs and the convenience for the customers, which has improved in the case of conversion of the TCCS into a co-operative bank.

D. Regional Rural Development Banks

In 1985, the Central Bank was mandated to form Regional Rural Development Banks (RRDBs) to provide credit in areas and for target groups which hitherto had not been served by banking facilities. Other objectives include the provision of services for the development of agriculture, cottage and small-scale industry, fishing industry, commerce, and other development activities in rural areas. Originally funded with 100 per cent equity from the Central Bank, the emphasis of the RRDBs was by design on lending. Nevertheless, four of the six already founded banks (with 15 branches altogether) showed a strong deposit mobilization performance (Rs 8.2 million as at 21 March 1986), paying 10% interests for savings and 12% for fixed deposits. However, one has to assume that most of these savings are rather coming from other financial institutions than from the target type of clientele. At least from the point of view of deposit mobilization one has to question these newly created financial institutions, given the abundance of financial institutions already existing in rural areas.

E. Savings Schemes in Government-Supported Projects

In the last few years, various government-supported projects and programmes for the agricultural sector have been implemented, which also include the operation of small savings schemes. For example, the promotion of savings groups have been tried within Farmers' Associations and Associations of Water Users[1]. The technique normally adopted is to tie the grant of credit to the making of a savings deposit. To link up savings and credit is also one of the objectives of a pilot project by the government in the Kalutara District of Sri Lanka which intends to create rotating savings associations among the estate worker population (Silva, 1985). In another pilot project - the People's Participation Programme - regularly savings are stimulated within groups of small farmers to be used for income generating activities and social purposes (Abrew, 1987). The present government also plans to introduce an ambitious pension and social security benefit scheme for farmers which is aimed at - among other objectives - fostering saving habits (Liyanage, 1987). An assessment of the achievements of these efforts to mobilize rural savings is not possible due to the lack of statistical documentation.

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[1] For a description of the intended savings schemes in these projects see Hewavitharana (1987a, pp. 10-11).

IV. Hoarding and Informal Savings (and Credit) Activities in Rural Areas

A. Hoarding

No quantitative estimates are available to gain a more concrete idea of the magnitude of hoarding in the Sri Lankan economy. However, the existing evidence suggests that hoarding is a widespread phenomenon, especially in rural areas. Hoarding takes place mainly in the form of investments in gold jewellery. This preference is less due to an insufficient supply of formal savings opportunities in rural areas, but rests mainly on the convertibility of gold into cash at short notice in the rural markets, serving in the meantime as an inflation hedge. Gold jewellery serves also as an excellent security for raising loans or pawning in the rural financial markets (Bouman, Houtman, 1987). This indicates that the availability of safe and attractive savings instruments alone is not sufficient to reduce the preference for hoarding gold. Only if holdings of savings accounts will also imply easier access to credit it can be expected that this form of investment will be reduced.

B. Informal Savings Arrangements

There is a variety of informal group arrangements for savings in Sri Lanka[1]. A few of them save in commodity form, while some save for a specific purpose, such as pilgrimages. Others, such as death-aid societies, sometimes collect regular contributions and lend idle funds. Finally, arrangements are made through an organizer to whom funds are regularly given for a period of safekeeping, to be returned at the end of the period. A typical and more widespread example for informal savings arrangements is the Sarvodaya Shramadara Movement (SSM). The SSM is a widely distri-

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[1] For a more detailed description and analysis of informal savings and credit arrangements in Sri Lanka see Bouman (1984).

buted network of childrens' savings accounts, existing since 1980. This scheme is now operating in more than 2,000 villages, with about 126,000 accounts, and has mobilized up to 1987 around Rs 6 million (Bellows, 1987, pp. 74-78). Funds are collected by unpaid pre-school teachers, deposited at Sarvodaya district centres, and finally invested in fixed deposits at the National Savings Bank with an interest rate of 13%. The children are repaid 11%, the difference being used to meet its expenses. Although there are plans to expand savings and credit operations to meet also adults by using the extensive Sarvodaya infrastructure, the SSM programme is still strongly savings-based, and funds are not subjected to be re-invested in the rural sector.

Savings and credit activities are most common in Cheetu-Funds, the Sri Lankan-type of rotating savings and credit association. Finally, there are individual money lenders who are concentrated more on the lending side of informal financial markets. Both the economic performance of Cheetu-Funds and the range of non-institutional lending are analyzed in the subsequent sections.

C. Cheetu-Funds

The most popular type of informal financial institution in Sri Lanka is Cheetu[1], a rotating savings and credit association, similar to those found under different names in all part of the world. The basic formula is that a group of participants makes regular (small) contributions to a fund, which is given to each member in turn[2]. After twelve months each player has had a turn, and the Cheetu will disband or start a new cycle. Cheetu rules, which are decided at the first meeting, vary from place to place, and may differ with regard to the number of players, length of

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1 At village level various Cheetu systems can be found; for example, Parum Cheetu, Sangangu Cheetu, Palee Petti and Athmoru.

2 For a comprehensive discussion of the nature characteristics, and dynamics of the Cheetu System in Sri Lanka see Fernando (1986b).

interval, amount of contribution, and the way to determine rotation (order of enlistment, negotiation, lottery or auction).

The Cheetu's combine savings with lending. Members appreciate the discipline of contractual group savings by which they gradually accumulate a lump sum on small contributions. The attraction is that most participants have access to this sum at an earlier date than when saving individually. A Cheetu involves little administration. Recipients are seldom requested to provide collateral, guarantors, or other forms of security. The successful organizer is usually a business person with a solid financial reputation, who has himself a professional interest in savings schemes because of the opportunity these schemes offer for acquiring working capital. To the saver, the attractive part of these arrangements is that savings deposits create a line of credit in times of need. The saver-borrower values especially the quick accessibility and flexibility of these savings schemes.

D. Non-Institutional Credit

According to available data, the informal sector has been, and probably still is, a dominant source of credit to the rural economy. This is striking after four decades of concessional credit schemes for the agricultural sector under which institutional credit is granted at highly subsidised rates of interest[1]. Although the informal sources have somewhat declined in importance - for the 1980s they were estimated to be about 50-60 per cent of total borrowings in the rural sector[2] - they still continue to dominate the rural credit market in areas where the institutional lenders are absent or ineffective, and where the access to formal credit is extremely poor.

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[1] For an overview of past trends and present policies in institutional lending to the rural sector in Sri Lanka see Silva (1987).

[2] See Central Bank of Sri Lanka (1984) and Department of Census and Statistics (1986).

The demand for non-institutional credit for agricultural purposes arises mainly from the poor farmer (operators of mini and small holdings, marginal farmers) which lack acceptable collaterals and access to institutional sources. However, there are also those farmers who have been disqualified for institutional loans under the different concessional credit schemes due to their defaults. Finally, farmers who have principally access to formal financial institutions may resort to the non-institutional section because of the bothersome procedures, the hidden costs and other inconveniences involved in formal loan transactions. There might also be the fear of having to face legal proceedings in case of default. On the other side farmers may prefer non-institutional sources to formal sources because they are more convenient, readily accessible, procedures are simple, formal collateral not required, lending conditions and repayment terms are flexible, credit not limited to crop production but available for consumption and emergency needs as well[1]. Consumption credit requirements of the poorer classes originate in numerous "emergencies" associated with crop failures, natural disasters, illness, unforeseen events, lump sum expenditures as in education and ceremonies, and unfavourable trends in product markets. This area of credit is traditionally not met sufficiently by institutional sources.

There exist numerous types of suppliers with widely different types of objectives in the informal credit market, including friends and relatives, landlords, village boutique keeper, trader cum money lender, produce collectors, commission agents, professional and semi-professional money lenders[2]. The characteristics of the different non-institutional lenders and their operational modes are strongly related to the size of farms, their productivity levels, frequency patterns of cropping, irrigation conditions, extent of diversification and sectoral composition of the

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1 Estimated to be about 50 per cent of all loans of the non-institutional section to farmers.

2 For a description of the profile and operational modes of these different types of non-institutional lenders see Hewavitharana (1987b, pp. 6-11).

rural economy, socio-cultural features and other aspects of rural agriculture and of rural society.

The most important features of informal sector loans are low transaction costs (on both the lending and borrowing side) due to low overhead costs, simple procedures, quick disbursement, easy accessibility, flexible methods, and intimate local knowledge as well as access to credit without (real) collateral requirements. An estimate of the interest rate structure of informal credit market indicates that, contrary to the popular belief, the average interest rate (30-40% per annum) has not been exorbitantly high (Fernando, 1987). A significant proportion of the volume of loans have been transacted at rates which are not out of line with the rates prevailing in the formal sector if adjusted by the difference of transaction costs minus subsidies. The large share of interest free loans extended by friends and relatives is an indication of the importance of the complex social relationships in the informal rural credit market. In the case of professional money lenders opportunity cost and risk premium seem to be much more significant in explaining the interest rates charged than administrative costs and monopoly power.

Disappointment with institutional credit schemes for the agricultural sector and the appreciation of the relative advantages of non-institutional lenders which obviously are better adapted to lending in a rural community have led to the proposal to incorporate non-institutional credit into the institutional credit network. Measures proposed to this end are for the institutions to appoint loan agents among non-institutional lenders, provide them capital or refinance facilities and leave them with full freedom to determine eligibility and to recover loans (Ministry of Finance and Planning (1984). However, there is no exposition so far of the mechanisms and the ways in which such measures would help to solve the rural credit problem in Sri Lanka.

V. Reform Proposals for Mobilizing Savings for Rural Development

Whether the potential for mobilizing rural savings in Sri Lanka is exhausted or not can only be judged by an assessment of the savings capacity of the rural population. Although statistically not documented, there are several indications that savings in jewellery, foodstuffs, materials and other inflation hedges is still a widespread phenomenon, especially with the poorer part of the rural population. This indicates that, despite the progress made in mobilizing rural deposits, there is still room for strengthened efforts by pursuing more flexible interest rate policies and enforcing competition among the different financial institutions. However given the prevailing excess funds within the financial sector on the one hand and the insufficient supply of agricultural credit on the other, additional savings mobilizing institutions may not be seen as a priority issue. Nevertheless, several distortions with respect to savings mobilization exist in the rural financial market which may also have negatively influenced the lending performance in rural areas. This will be discussed in the following sections.

A. The Preferential Status of the National Savings Bank

A serious distortion concerned with deposit mobilization through the Sri Lankan financial system is the preferential market position of the National Savings Bank. The inflexibility of interest rates on deposits is mainly the result of the leading role of the National Savings Bank, whose fixed deposit rates are frequently set independent from market forces. It competes with commercial banks for deposits at whatever rate is necessary to keep its market share (regardless of cost considerations) which is easily achieved due to its widespread deposit-collecting agencies. The NSB has had especially no incentive to reduce its deposit rates to levels consistent with the yield on its assets (long-term government securities at a fixed yield), because the resulting negative differential (or loss) has been covered through transfers from the Government. A removal of these subsidies would oblige the authorities to adjust the yield on long-term government securities, in line with other market rates, considering the risk and maturity. Another action for increasing the yield of NSB's assets would be to diversify a part of its portfolio into assets with higher yields than the government securities[1]. This movement could include the initiative of lending secured by deposits at rates comparable to overdraft facilities in commercial banks. However, this can only be realized as a longer-term strategy, since NSB's present capacity to embark on direct lending seems to be extremely limited. Nevertheless, such a diversification away from government securities would lead to placing upward pressures on government borrowing rates.

A further issue which has to be questioned in relation to NSB's preferential status is whether it needs the tax incentive as a compensation for not being able to accept interest-free demand deposits, to extend high-yielding overdrafts against its deposits, and to conduct other lucrative banking business; in this context one has to bear in mind that NSB is exempt from reserve requirements, has a risk-free asset portfolio, has not been forced to produce profits, and would be expected to have lower operating costs than banks. The National Savings Bank has been used by the Government to collect savings and also to finance the government deficit. To achieve this goal, tax incentives and subsidies have been provided for this institution. However, one has to ask whether the Government could not raise equal or larger amounts at lower costs by selling some type of government securities directly to the public at market-oriented of interest rates? Although this would lead to higher government interest payments, the government deficit would not necessarily increase due to the savings from the removal of the subsidy and additional income tax receipts.

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[1] Although since 1984 NSB has been authorized to invest up to 40 per cent of its portfolio in such higher-yielding assets, it has been slow to do so.

B. The Insufficient Link between Savings and Lending Activities

A severe bottleneck in the Sri Lankan financial system is the weak link between savings and credit activities, which is especially the case within rural financial institutions. Several factors have contributed to this weak link. Firstly, this is partly the outcome of the existence of specialized savings and credit institutions like the National Savings Bank and the National Development Bank. Secondly, this failure might be seen as a result of the comprehensive concessional loan schemes and re-financing facilities for the agricultural sector, which reduce the effort of financial institutions to mobilize savings for lending in rural areas. These negative side-effects of subsidized loan schemes particularly undermine the intermediation process of those financial institutions, like Rural Banks and Thrift and Cooperative Credit Societies, which would be most capable of enforcing the savings/credit link due to their relative closeness to their clientele. Thirdly, given the below-market level of interest rates for rural credits, the involved credit rationing mechanism favours (real) collateral-based lending, and discriminates the supply of credit for higher risk <u>and</u> higher yield projects. Interest rates for credit which would allow the coverage of higher transaction costs in rural lending would not only ease the access to credit problems for smaller farmers and businessmen in rural areas, but would also open up the option to accept savings deposits or the underlying depository behaviour as security for loans. This process would be further strengthened by measures to increase the competitive environment for the existing financial institutions which at present are operating in rather isolated markets.

C. The Problem of Savings Outflows from Rural Areas

It is a widespread claim in developing countries that savings mobilized in rural areas are not used locally but transferred to urban areas, and Sri Lanka is no exception. The limited lending activities in rural areas may partly be explained by stressing the higher transaction costs for rural lending which cannot be covered by the existing interest rates. However, it has also to be recognized that the well functioning of rural financial markets largely depends on the economic vitality of the farmers and rural households they serve. Although an in-depth treatment of the claimed lack of viable projects in Sri Lanka's agricultural sector is beyond the scope of the present study, it has to be kept in mind that distorted exchange rates, export duties and inefficient agricultural markets as well as other government interventions are favouring, in general, investment projects in urban areas. If farmers receive relatively low prices for their products their ability to use financial markets is diminished: hence they are less willing to borrow, less able to repay loans, and have less capacity to save. Thus, the problem of rural savings not being used in rural areas can rather be eliminated by improving the internal terms-of-trade in favour of the agricultural sector than by re-channelling the occurring savings outflows through concessional credit schemes back to rural areas.

D. Policy Options Towards the Informal Financial Sector

Attempts to regulate the informal financial activities by public authorities have to be judged as critically as proposals to improve the functioning of local savings groups by enforced co-operation with rural financing institutions[1], or by transforming them into formal financial institutions. The reasoning behind this reservation is that the relative success of the informal and semi-formal groups critically depends on the fact that they are far less controlled (or controllable) than organized financial institutions. A more promising alternative can be seen in dismantling the preferential status of the NSB and re-financing allowances of the various credit schemes for the agricultural sector. This could enforce competition among the existing formal

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[1] For such a proposal see, for instance, Silva (1983).

financial institutions and lead to financial innovations which would benefit small savers and investors in the rural (and urban) area.

External assistance for savings mobilization activities in the informal (financial) sector is seriously confronted with the problem that - due to the formal procedures needed to channel foreign aid to the target groups - Government's capacity to control these activities will increase, thus reducing the informal character of savings and credit societies, for example. Furthermore, any kind of external support is contradictory to the internal logic and economic rationale of self-help organizations, which derive their relative economic advantages against formal institutions just from their independence from the Government and other organizations, external donor agencies included.

Multilateral aid organizations have in the past pursued the approach of providing cheap credit to Sri Lanka for special target groups within the poorer part of the rural population, which has been assumed to be unable to save. However, in practice, target groups - such as small farmers and fishermen - of the informal sector only very seldom have actually benefited by these credits. To the extent that the formal sector has been finally the recipient of these aid programmes, there has been an additional discrimination of the production activities in the informal sector. Paradoxically, informal production was confined to be financed internally or with credit from informal financial institutions, at interest rates which have been significantly higher than those in the organized financial sector.

Table A1 - Nominal and Real Rates of Interest on Rural Credit Schemes, Sri Lanka 1970-1986

Year	Nominal Interest Rate		Inflation Rate[a]	Real Interest Rate[b]	
	Short Term Lendings (%)	Medium Term Lendings (%)	(per cent)	Short Term Lendings (%)	Medium Term Lendings (%)
1970	9	9.5	5.9	23.1	3.6
1971	9	9.5	6.7	2.3	2.8
1980	9	9.5	26.1	-17.1	-16.6
1981	9	9.5	18.0	-9.0	-8.5
1982	9	9.5	10.8	-1.2	-1.3
1983	9	12.5	14.0	-5.0	-1.5
1984	9	12.5	16.6	-7.6	-4.1
1985	9	12.5	1.5	7.5	11.0
1986	9	12.5	n.a.	n.a.	n.a.

[a]Annual changes in the consumer price index. - [b]Nominal interest rate minus inflation rate.

Source: Data provided by the Central Bank of Sri Lanka; own calculations.

Table A2 - National Savings Bank's Deposits by Size, Sri Lanka, End-1983

Deposit Range	Branch Sector		Postal Sector		Total	
	Number of Accounts	Amount (million of Rs)	Number of Accounts	Amount (million of Rs)	Number of Accounts	Amount (million of Rs)
(Rs)	(Percentage Distribution)					
Below 10,000	87.5	18.5	99.5	65.8	97.5	28.0
10,000 - 100,000	11.7	44.8	0.5	21.4	2.4	40.0
100,000 - 200,000	0.6	18.0	-	7.3	0.1	15.9
200,000 - 300,000	0.1	4.8	-	5.5	-	5.0
300,000 - 400,000	0.1	4.9	-	-	-	3.9
Over 500,000	-	9.0	-	-	-	7.2
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: Data provided by National Savings Bank; own calculations.

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