THE IMPACT OF INTEREST RATES ON SMALL BUSINESSES AND LOCAL ECONOMIES

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ABSTRACT

Many debates have been waged about the effect of the interest rate ceilings on the provision of financial services to small businesses. It has been considered as one of the major constraints in small business access to capital and it is also considered a major inhibitor of small business development. The present study attempted to determine whether interest rate ceilings should be undertaken or not, and how in a South African socio-political context this would help small business development. Concomitantly, it was considered how the interest rates affect small businesses according different purposes, size and terms of loans.

A case study method was used to pursue this research. The case study of Mamelodi Township (Pretoria) and Kildare/Jonkilanga village (Mhala District - Northern Province) were undertaken. Open-ended interviews with borrowers and financial institutions (providers) were conducted. The result of the interviews was analysed and reinforced with an analysis of national and international secondary literature.

One of the main findings of the research was that interest rates ceiling are necessary and substantial in helping small business development. It was established that interest rate ceilings have to be considered in a flexible manner, according specific conditions of small business activity. It was also concluded that interest rate ceilings have to be a consequence of a regulatory framework which enables small business access to capital, and, thus, development of their local community. The result of the research likewise, has indicated that for small, short term, working capital loans, the impact of interest rates on borrowers is smaller than for larger, longer term borrowers. The effect of the circulation of resources in a community in the case of a lower level interest rates deserves more investigation but there are primary indications of some positive impact on.

DECLARATION

I declare that this report is my own, unaided work. It is submitted in partial fulfilment of the requirements of the degree of Master of Management (in the field of Public and Development Management) in the University of the Witwatersrand, Johannesburg. It has not been submitted before for any degree or examination in any other University.

Horácio Lucas Zandamela

24 December 1998.

DEDICATION

Particular tribute to my spouse Hermenegilda, my baby Ornila and my cousin Telma.

To my parents and family

Horácio Lucas Zandamela

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TABLE OF CONTENTS

LIST OF FIGURES

GLOSSARY OF TERMS

1. Interest Rate

The term 'interest rate' is described in different ways by various authors. However, the different definitions ca. be summarised as fc.iows: "The rate of interest is the percentage of premium paid on money at one date with money to be in hand one year later" (Fisher, 1954, p.13).

2. Consumption or Personal Loans

Personal loans are loans of individuals for personal purposes rather than those arising out of business relations.

These kinds of loans are taken to supplement an income that is inadequate to meet one's present requirements, while one trusts to future resources for repayment. It follows, therefore, that such loans are made by the borrower for the sake of correcting an income stream, the time frame of which is unsatisfactory. Some people receive their income in very irregular and unequal instalments, while their cash outflow may likewise have an irregular time schedule (Fisher, 1954, p.357).

3. Productive or Business Loans

Business loans are those for productive purposes, in contrast to consumption loans. This kind of loan constitutes the most important class of indebtedness all over the world. However, in these loans for productive purposes, ultimately the business owners have the objective of enjoyment, either for themselves, their families or for others (Fisher, 1954, p.359).

4. **Short Term Loans**

"Short term loans are defined as those growing out of periodical income variations. These loans are usually obtained at a specified time according to cyclical change on productive activity. The aim is to compensate the periodical weakness of the income stream" (Fisher, 1954, p.360).

5. Long Terms Loans

Long term loans are loans for investment that last long period of time. These kinds of loans are normally taken for new construction, replacement or for the improvement of a plant, or purchasing equipment (Fisher, 1954, p.365).

6. Small Business

The definition of small business is variable. Some authors for instance, (Harper, 1984, p.2) state that "the scale of a business needs only to be defined for a specific purpose and there is no point in attempting to produce a universally or even a nationally acceptable standard."
For MacFarlane small business is "one which is independently owned and not dominant in its field of operation. Such businesses are often owned and managed by the same person. Many of them have no paid employees. Initial financing typically comes from the owner's savings or from friends and relatives. The business serves a local market and most of the workers live in the home community" (MacFarlane, 1977, p.4).

7. Elasticity

The degree of responsiveness of demand or supply to a change of price.

8. Cross Elasticity

A measure of the influence of the price of one good on the demand for another. The cross elasticity measures the degree of relationship between the two goods.

9. Price and Cross Elasticity of Demand

When two commodities which are close, substitutes one for another, and are in competitive demand, an increase in the price of one will increase demand for the another. The effect of this change of price of one commodity on the quantity demanded of the other is the cross elasticity of demand.

10. Price Ceiling

A condition where the price is 'externally' controlled so that it cannot rise freely in response to changing market conditions. When this is set below the equilibrium price it will cause a shortage. 'Hidden costs' of administration often result in targeted consumers being harmed and not helped by the inefficiency.

11. Multiplier

A multiplier is the effect that results in total income in a certain community because of changes made in investment spending in that community.

ABBREVIATIONS

AMEDP: Alliance of Micro Enterprise Development

CGAP: Consultative Group to Assist the Poorest

CSBP: Centre for Small Businesses Promotion

CSP: Community Service Providers

CSS: Central Statistic Service

DDD: Draft Discussion Document

DTI: Department of Trade and Industry

EAP: Economically Active Population

FFC: Finance and Fiscal Commission

GDP: Gross Domestic Product

GEAR: Growth Employment and Redistribution

LEDEC: Local Development in Eastern Cape

MERG: Macroeconomic Research Group

MFIs: Micro Finance Institutions

NRDP: National Regional Development Programme

ORD: Office for Regional Development

RDAC: Regional Development Advisory Committees

RDP: Reconstruction and Development Programme

Repo Rate: Rate charged by the South Africa Reserve Bank when lending money to Commercial Banks. The Repo Rate was previously called Bank Rate.

SCF: Survey of Consumer Finances

SMMEs: Small, Medium and Micro Enterprises

CHAPTER 1

INTRODUCTION

1.1 Introduction

In this chapter, debates surrounding the need to broach the interest rate levels in small business as well as their context in South Africa will be discussed.

1.1.1 Background

The need for the development of small businesses has increasingly become a matter of strong debate around the world and in South Africa in particular during the last five years. It is considered as a critical factor in the process of transformation, particularly in those countries that are making efforts to move towards economic development. Small business plays an important role in contributing to employment, poverty alleviation and overall economic growth. The South African economic situation concerning small business is illustrated in the Annual Review of the Department of Trade and Industry (1997, p.3). The contribution of small business to the GDP is about 43% in the agricultural sector, 80% in Community Service Providers (CSP), 44% in construction, 48% in trade, 33% in catering and 11% in manufacturing. The contribution to employment is 55,8% in the agricultural sector, 38,7% in construction, 50,4% in trade and 17,2% in manufacturing. The significance of these statistics becomes more evident when it is considered that "about 6.5 million members, or 45% of the Economically Active Population (EAP) are either unemployed or employed outside the formal sector." In addition, "as many as 400,000 work seekers had entered the economy in 1994, of which less than 7,5 per cent found employment" (AMEDP, 1996, p.3).

A major factor limiting small business development in developing countries is the scarcity of capital. It is well known that capital for business is obtained by borrowing from financial institutions (banks, and some specialised NGOs, etc.). Loans imply that repayment is made with an interest charge. This charge is the cost of money borrowed, known as the interest rate. The levels of this charge determine to what extent business can have access to finance and, consequently, be able to start or develop and improve. The impact of interest rates on borrowers and their local economies therefore becomes critical to the success or failure of many small businesses. Considering the importance of the informal sector, there is a definite need to review legislation dealing with small business access to finance.

Interest rate ceilings, imposed by the Usury Act, on the provision of financial services to Small, Medium and Micro Enterprises (SMMEs) as well as the exemption of loans under R6 000 shows the overall context of the interest rate debates. The proposed amendment of the Usury Act to DTI to increase from R6 000 to R50 000 as the base for interest rate ceilings is a consequence of that interest rate debate. Interest rate ceilings constitute a fundamental issue that needs a decision from government institutions in conjunction with key stakeholders to ensure adequate provision of financial services to SMMEs.

The issue of small business development and their local economies is clearly related to the interest rate (cost of money borrowed). What this relation is and to what extent it affects small business is a matter of serious debate. Some argue for lower interest rates to promote small business and others argue against it. This debate is based on two distinct schools of thought.

The neo-classical school argues that lower interest rates lead to increased inflation and thus decreased economic growth and that capitalism is a paradigm of self adjustment without intervention and with a tendency towards full employment of resources. The policy implications of this perspectives or school of thought, as pointed out by Adelzadeh are:

> Reduce the power of government to intervene in the economy and shift their power to the market; integrate the economy into the world market through trade and financial liberalisation; deregulate the economy as a whole, specifically labour and financial market (Adelzadeh, 1996, p.42).

In contrast, the Keynesian vision is one of active government participation in the economy. This school of thought argues that in a market economy, there is no inherent tendency towards full employment of resources. Proponents of Keynesianism suggest that the level of growth be determined by the overall demand in the economy. This is composed of consumption, investment, government expenditures and exports. The policy implications that stem from the Keynesian perspective are:

> Promote expansion in demand for domestic outputs to increase growth and employment of resources and labour; call for fiscal and monetary policies for stabilisation purposes; accept that increasing exports are important, but call for measure in the pace and extent of integration into the World economy to ensure that the expansion of the domestic market is underpinned by expanded domestic production (Adelzadeh, 1996, p.43).

In the present context of South Africa, the RDP conceptual framework for Reconstruction and Development Programme in South Africa, based on demand-side interventions, such as tariffs and subsidies, fits well in Keynesian perspective. The RDP points out:

- We must improve the capacity of the financial sector to mobilise more resources and to direct these to activities set out in the RDP, from housing to small medium-sized enterprises (1.4.23.2).
- If necessary, the democratic government must provide some subsidies as a catalyst for job-creation programmes controlled by communities and/or workers, and target appropriate job creation and development programme in the most neglected and impoverished areas of our country. Ultimately, all such projects should sustain themselves (4.3.5).
- Financial institutions must assist both by funding individual programmes to meet needs, especially housing, and by improving their services to small-scale producers and the black communities (6.5.17)

(CSBP, 1986, p.1).

In contrast the government's Growth, Employment and Redistribution (GEAR) economic framework fits well with the overall context of the neo-classical vision, an outward orientation and a focus on supply side measures. GEAR indicates:

- A Small Business Centre attached to the Department of Trade and Industry;
- Ntsika Enterprise Promotion Agency to provide non-financial assistance;
- Khula Enterprise Finance Limited for wholesale loans;
- Khula Credit Guarantee Limited for loan guarantees;

- Pre-shipment export finance guarantee facility to expand access to working capital; and
- Competitiveness Fund for consultancy advice on technology and marketing (CSBP, 1998, p.2).

The problem of interest rate ceilings imposed by the Usury Act, is considered an inhibitor on the provision of financial services to small businesses. This perception is directly affected by the [illegible] for the deregulation of the financial market in the context of r[illegible]. This means that every business has to adapt and comp[illegible] market conditions. On a micro level, this approach limit[illegible] development for small business activities because of the general shortage of capital and weak level of small business development. Also, due to the legacy of the system of apartheid policies, discrimination among groups ensured "that the percentage of entrepreneurs from disadvantaged groups shrinks as the business becomes larger and more formal" (DTI, 1997, p.6).

Therefore, there is a definite need for reflection and a need for investigation into search measures to help define appropriate legislation to enable small businesses to access finance and to sustain their development.

This reflection has to take into account that small business associations in South Africa have been divided along ethnic lines and that up to the present, the South African Chamber of Business (SACOB) has been unable to provide more than superficial support to their members of commerce. This is highlighted by DTI, (1997, p.12), who say "... the traditionally white chambers revealed some capacity, but little ability to diversify into technical or specialist fields on behalf of their members." It continues to say that "steps are being taken to assist chambers of commerce to develop their capacity through a R4 million joint ventures with the Danish aid agency Danida" (DTI, 1991, p.12).

Considering the importance of finding measures for adequate provision of financial services to SMMEs and considering the importance of the informal sector and the geographical location of small business, this study was undertaken. This study has used a holistic case study framework, based in Mamelodi township (as a representative of a urban community) and Kildare/Jonkilanga village (as a representative a rural community).

1.1.2 The National Context

1.1.2.1 South African high interest rates

In addressing the national context it is relevant to begin by addressing the reasons that determined the high level of interest rates during the last decade in South Africa.

If we look at historical data, we find that after SA's economy declined until the end of 1973, a general increase in economic activities arose mainly because of the sharp rise in the gold price. By the end of 1974, South Africa experienced an inflationary situation that weakened the economy in such a way that it was not possible for the country to avoid the effects of the prevailing recession in the world context. Although in 1980, because of the high gold price, the economy reached a peak of revival and by the end of the second quarter of 1981 the cyclical process ended. In the following years, because of the low gold price, high interest rates and protracted drought, the situation of the South African economy after 1981 until the middle of the eighties was characterised by the worst recession in the domestic economy since the nineteen thirties (ORD and RDAC, 1991, p.40-41). (See Appendix C for graphic illustration).

The rise of interest rates needs to be explained in the general context of the South Africa economy. First, the performance of the national economy during the period from 1975 to 1990 declined. The negative move of the GDP from 5,4% during the sixties to 2,8% during the seventies until the extreme figure of 1,3% in the eighties illustrates that decline. This trend can be explained by the deterioration of the financial position of the farming industry in general and the decline of the dollar price of gold in the international market. This was because of the competition of that product produced by Canada and Australia. It is also important to note, as it is mentioned by ORD and RDAC that "... the oil crises and the general political unrest during the seventies resulted in a low level of industrial activity and investment as a result of the negative perceptions that arose within the country regarding long-term stability" (ORD and RDAC, 1991, p.46).

Second, another important factor is the excess of credit supply intended to increase the level of activities and investment in the manufacturing sector during the seventies. However this was reversed by the external factors such as the drought, a decline in the exchange rates of the Rand, extraordinarily high interest rates, a sharp increase in inflation, the decline in the gold price, the instability in the labour market, and so on.

Apart from the problems related to the gold price decline and consequently the negative impact on the foreign exchange earnings, and the negative operating results of the sector, the ORD and RDAC mention that the low level of skilled people hampered the growth of manufacturing. This resulted in a decline in productivity. The ORD and RDAC also mention the problem of the relatively large size of the public sector and the effect this had on the availability of scarce resources within the country. Naturally this led to high government consumption expenditure and a deficit before borrowing which led to an increase in tax pressure and interest rates, and therefore in the cost of capital (ORD and RDAC, 1991, p.47).

In connection to that increase in interest rates, it is important to observe the issue of net outflow of foreign capital resulting from the South African debt that leads to a decline in the availability of savings and the consequent shortage of capital to finance gross domestic fixed investment.

According to ORD and RDAC, (1991, p.47) "the net outflow of foreign capital resulting from the present debt standstill leads to a decline in the availability of savings since these have to be used to repay foreign debt and are therefore not available for the financing of gross domestic fixed investment".

Concurring to the same view MERG (1993, p.60) consider that, since the 1985 debt crises, South Africa has had to repay foreign debt, which has resulted in lower savings than otherwise being available domestically to finance domestic private investment and the public sector deficit.

MERG, continues to say that, because of the rise of the economy in 1988 that resulted in a 20 per cent increase in imports, consequently it reduced surplus of the current account to less than 1,5 per cent of GDP. This was at a time when capital outflows were over 4 per cent of GDP and the policy response was a sharp increase in interest rates an the imposition of import surcharges (MERG, 1993, p.61). (See Appendix C for graphic illustration).

The question of high interest rates is also associated with short term capital inflows experienced in the country. Short term capital inflows is attracted by high real interest rates because of the pressure to repay the money borrowed and the risk that is consequently involved.

GEAR addresses this issue of high interest rates indicating that "the lack of sustained long term capital inflows has made the balance of payment and the economy too reliant on short term reversible flows and consequently high interest rates." It also states that " the commitment to a stable real exchange rate and higher growth will also reduce the risk premium facing foreign capital inflows and this would then allow for lower real interest rates" (GEAR, 1996, p.13).

On the same issue, Adelzadeh, points out that "the GEAR forecast of increase in the flow of foreign investment into the country didn't result". Instead it "results in increase in the inflow of short-term capital which has in turn resulted in the rise in the volatility of the country's financial markets, placing severe upward pressure on interest rates in the absence of any other policy instrument" (Adelzadeh, 1996, p.80).

MERG indicates that:

> "During 1983 to 1985, monetary policy in South Africa was aimed at controlling inflation through high interest rates. Despite these historically high real interest rates, the exchange rate continued to depreciate" (MERG, 1993, p.63).

In addition they say that:

> "monetary policy was at times dictated by balance of payments developments, although generally this was in the same direction as needed in terms of the monetary objectives. Thus, for example there was an increase in domestic investment in 1988 that resulted in large increase in imports, which put pressure on the current account. Given the need to maintain a current account surplus to meet debt repayment commitments, the Reserve Bank was forced

to raise interest rates to protect the balance of payments, and thereby clamp down on the increase in expenditure" (MERG, 1993, p.63). (See Appendix C for graphic illustration).

The Reserve Bank plays an important role in monetary policy implementation. It influences interest rates through the control of the bank rate (rediscount rate). This rate is the base for the Reserve Bank to finance the banking sector. So, the rate the Reserve Bank chooses will influence the economy of the country as a whole.

According to MERG, (1993, p.71) the current policy of the Reserve Bank is to control the money supply with the interest rate as the main instrument, and with the objective of maintaining the external and internal value of the Rand. This policy is a shift in objectives followed during 1970s aimed at keeping the nominal interest rates low that resulted in negative real interest rates. The prevailing policy is not satisfactory because it is not addressing the needs of the majority of South Africa's population. A notable negative indicator is the high level of unemployment in the country. MERG, suggests a positive long-term rate of 2 per cent to reverse the prevailing recession of the economy.

From the above presentation one can assume that the central objective of the Reserve Bank is to control the price stability, through control of inflation rate. The Reserve Bank policy will obviously drive to maintain positive real interest rates but at low rates as this will be useful for less volatility in the economy.

One economist from the Standard Bank (January 21st, 1999) advocated that a very low interest rate could be dangerous for the economy in the long run by increasing inflation. It is important to have good return unless we want to experience the same situation as the economic crises of East Asia. He mentions an increased integration of the South African economy being one important factor that drove the increase of the interest rate in South Africa. For him the integration led to much fluctuation on the exchange rate that negatively affects the balance of payment of the country by increasing inflation. That is the reason for the Reserve Bank move to adopt the anti-inflationary strategy to control the situation. The Reserve Bank holds Constitutional independence and responsibility, which enables it to set the inflationary policy. Thus to stabilise the economic situation the Reserve Bank also had to increase the interest rates.

Continuing his presentation the economist said that, the dissaving trends in the South African economy led to the need for foreign inflow of capital to finance the economy. To compensate, the fiscal dissaving through the government budget results in the interest rate increase.

It is evident that the government fiscal policy adopted in the country also affects the level of interest rates. Therefore it is appropriate to think that the government has a role to create an environment conducive for business activity based in particular and specific policies directed to the micro level area. The importance of looking at the micro level is to help determine an appropriate policy for the micro lending industry.

However it is important to understand how the money flows from the Reserve Bank to the public. According to another economist from the South African Reserve Bank (SARB) (January, 24th, 1999), the Reserve Bank lends money to commercial banks at the Repo Rate (Bank Rate), and lends to business and household (consumers) at a Prime Lending Rate. The SARB function is concentrated at the macro level whereas the commercial focuses on the micro level.

The economist indicated that in real terms what happens is the flow of money in a way that the banks borrow money from the public at certain rate and come again to the public to lend the money with another interest.

He explained that the commercial banks borrow money from the public through deposits. Because of these deposits, commercial banks pay certain interest to the depositors. With the money the commercial banks lend to anyone in the public and charge a higher interest than that one paid to depositors. The difference in the interest paid to depositors (public) and the interest charged to borrowers (public) determine the bank's profit. This is the essence of the bank business, the economist concluded (January, 24th, 1999).

It is worth commenting that the gap between the interest rates charged by SARB to Commercial banks and the interest rates charged to business and household (consumers) is too high in South Africa. It can explain certain inefficiencies of the banking sector in South Africa. It can also explain the effect of imperfect competition in South African banking. More competitive banks would reduce this gap and therefore reduce the interest rate level in favour of the borrowers. The higher the interest rate levels the central bank lends to the commercial banks, the higher the interest rate charged to business and household (consumers) will be.

One can understand that it is necessary to keep the inflation rate low and therefore some increase in interest rates would enable more inflow of capital to compensate the lack of domestic saving. However, it is important to question the results of the lack of domestic saving at a micro level. It is important to realise that the lack of domestic saving doesn't enable the majority of the poor people of the country access capital and resources.

Many authors argue, and this is one of the central arguments of many reserve banks around the world, that high level of interest rates will chase away bad borrowers and those oriented to consumer purposes and encourage those for investment purposes. This seems to be doubtful. [1]

1.1.2.2. The general environment for small business development in South Africa

The South African economic environments are not accommodating enough for positive changes in SMMEs to play a strong role in job creation and poverty alleviation. This is because, on the one hand, we have the lack of investment in the sector. On the other, the banks are much too restrictive to give loans to the SMMEs.

As DTI points out, "the current levels of investment in SMMEs are inadequate for achieving the growth levels anticipated in GEAR. SMMEs receive approximately 2,6% of investment capital flows, through both formal and informal agents"(DTI, DDD, 1998, p.2). They also indicate that "according to the Council of South African Banks, there are 375 000 loans on the books of commercial banks that can be considered micro enterprise credit (R 4 billion, averaging R11 700 per loan)".

This situation is mainly because in South Africa the banks close their doors to SMMEs. The four large bank groups in South Africa dominate commercial banking. The way it operates was designed for a different economic system where commercial banking is separated from investment banking. The commercial banks do not give loans for those intending to start businesses if the amount they require is under R50 000. The argument presented is that the costs are too high for the banks in relation to the income they can earn on smaller loans. De Kock, a journalist of the Business Day, goes further saying "people in this category

[1] As will be discussed in the literature review, Chapter 2 (Stigitz & Weiss, 1998, p.43) contrast this approach.

who need to borrow money are usually stranded because non-governmental organisations and other retail finance institutions seldom lend more than R6 000, because of the fact that the Usury Act does not apply at these levels. Recently some changes seem to be emerging. De Kock also mentions a conference held in Cape Town la year, where Bob Tucker, Chief Executive of the Banking Council, gave an undertaking to the government that he would find a way for banks to make smaller business loans of between R10 000 and R50 000 available to the public" (Business Day, 1988, August 8).

As a result of this undertaking, the Council is putting together a scheme whereby entrepreneurs can access business finance. The scheme has two parts. The first part is where a support company is being formed which will employ mentors to help entrepreneurs to get their businesses off the ground from day one. "This assistance will include helping you to write a business plan, helping you to approach your bank for finance, helping you implement your business plan and even helping you approach suppliers for the best deal. The mentor will also help you monitor your business for at least two years" Bob Tucker said (Business Day, 1988, October 18).

The second is where the Banking Council is also projecting a company to help people who can not provide security for loans, alongside Khula. The banks will take a portion of the risk.

Banks usually reject SMME loans because of the insufficient collateral they present. Although the existence of Khula Credit Guarantee Scheme, from 1996, as a State-Owned organisation, "that has the responsibility of indemnities up to 60 percent of the loss in case of business, which has been financed by one of the participating banks, fails. The effects do not show any progress of their utility towards supporting SMMEs developments. Only 633 indemnities have been granted according to DTI (DDD, 1998, p.2).

For the Banking Council the maximum loan that will be indemnified is R600 000 and the bank must vouch that the business will be viable and that the owners have the ability and experience to run the business successfully. The percentage indemnified will soon be increased to 80 percent at a three-percent indemnity fee.

De Kock, continuing his argument also observed that "more than half of all people who borrow from micro lenders use the money to buy food or to pay accounts. Only 1,9 percent approach moneylenders to borrow money for their own businesses" (Business Day, 1988, October 18). The result of the present research supports this assertion (See Chapter 5). The percentage indicated seems to be too low. However what is important to note is the high level of misuse of the money among many borrowers.

Because micro lending for purposes of consumption generally goes hand-in-hand with lending to people without collateral at high interest rates, some have branded it as irresponsible action by "loan sharks" who are purely out for their self-enrichment.

Another aspect referred by De Kock is about the criticism of loans for consumption purposes indicating that "... this view has been disproved by studies such as that by Du Plessis and the point has been made that small loans for the purpose of consumption provide an essential service to people who are often desperate for money and have nowhere else to turn" (Business Day, 1988, October 18). This situation must be carefully analysed in a development perspective. Although the loans for consumption purposes do help people, it is only in an immediate future. It is also important to look at loans that lead people to charge their lives permanently.

The issue presented above is related to issues such as the current exemption under the Usury Act which, enables micro lenders to charge high interest rates which are currently being addressed by industry and government. Also what has being addressed is the practice of handing over ATM cards and PIN numbers to micro lenders; ethical matters of lending for consumption without educating people on how to get out to debt; and the need for more regulatory environments.

De Kock, comments that "while it is often said that people approach micro lenders because they cannot get small personal or business loans from the formal commercial banking sector, this is not always true". She continues saying "strict criteria for approving small personal and business loans do apply, but many banks already offer a service of some sorts whereby people can borrow small amounts of money up to R6 000" (Business Day, 1988, October 18). Although this can be true, in real terms, people face enormous difficulties in benefiting from such facilities because of the shortage of collateral required. Also the problem of a lack of adequate information adds to the difficulties of people trying to benefit from the facilities mentioned above by De Kock.

In relation to the scenario presented above, Du Plessis suggests that "there is an urgent need for a good relationship between micro lenders and formal banks" (Business Day, 1988, August 8). In addition, he says that "micro lenders are dependent on banks for frequent banking services for their outlets and clients, banks again benefit from the number of accounts opened and the income from transaction costs." He concludes "there is huge potential for new banking business on a national level, should the formal banking sector and the micro lending industry come to terms on the accessibility of the electronic banking system. Those formal banks currently giving the industry a cold shoulder might have much ground to recover, should future developments be in favour of the micro lending industry" (Business Day, 1988, August 8). One can support this view in a sense of the need to remove bias between the Banks and Micro Lenders sectors and look forward to a new arrangement where Banks and Microlenders have space to contribute. This is not easy in practical terms. Perhaps a revision of the current incentive structure can contribute to a more open attitude from the banks to the micro lending industry.

In South Africa, some micro lenders are looking seriously at transformation in community banks. Maybe this will cause banks to be more conscious of the micro lending industry.

I would like to argue that community banks could be one of the ways to approach the issue. Yet they would have to be more efficient than the commercial banks to lower their charges and become competitive. They have to present relative efficiency compared to commercial banks. This also requires a commitment to the community where services are due to motivation and not profit. Also although questionable, the merit of the present proposed amendment of up to R50 000 might be one important step towards banking sector involvement in micro lending industry.

1.1.3 Research Problem

The relevance or irrelevance of the small business' interest rates to borrowers and local economies, according to loans for different purposes and with various terms, has been a matter of much controversy among authors. In Chapter 2, discussion among different schools of thought about interest rates will be presented. This investigation is aimed at explaining the effects of interest rates on the demand side and to assist in policy formulation regarding the possible support for ceilings on interest rates.

In this Research Report, the assumption is that interest rates on small, short-term loans and loans for working capital purposes do not impact on borrowers significantly. This works differently for the case of loans that do not generate short-term cash flows, such as consumption, education and housing loans, as well as fixed asset loans, the impact of interest rates is much greater, especially as the loans become larger and the loan terms longer.

To help in understanding the research problem presented above, the following diagram gives a graphic representation

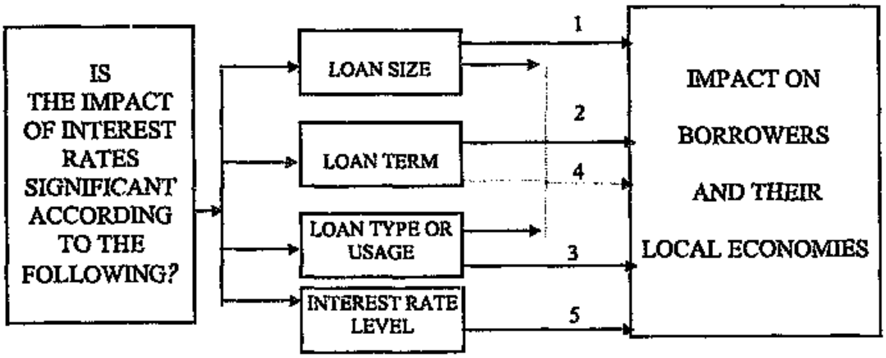


Figure 1

1.1.4 Statement of hypothesis

1.1.4.1 Hypotheses 1

For small, short term, working capital loans, the impact of interest rates on borrowers is smaller than for larger, longer terms, such as consumption, housing, education and fixed asset loans where the impact of interest rates on borrowers is significantly greater.

This hypotheses will attempt to confirm that the impact of interest rates on borrowers is lower in the case of small, short term, working capital loans that generate cash flows almost immediately, than in case of larger, longer term, consumption, housing, education or fixed asset loans which do not generate short term cash flows.

In this research the hypotheses will be proved.

1.1.4.2 Hypotheses 2

The circulation of resources in a community is higher in the case of lower levels of interest rates.

The hypothesis will attempt to confirm that the impact of interest rates in a community is higher in the case of lower levels of interest rates that generate high circulation of resources than that of higher levels of interest rates that do not generate high circulation of resources in a community.

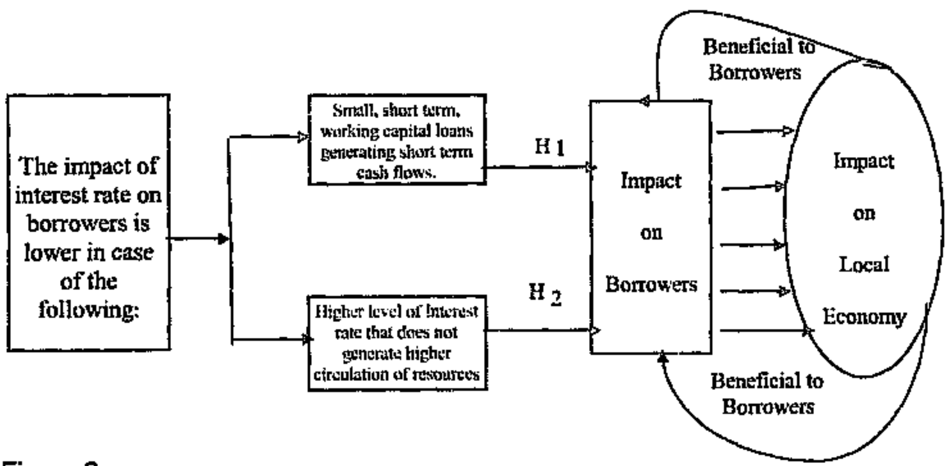


Figure 2

1.1.5 Structure of the report

Chapter 2 is a review of the literature on the interest rates' issues, where some of the debates surrounding the effect of interest rates levels on borrowers are analysed. Chapter 3 presents the research methodology used in the study. Limitations that have to be taken into consideration in this study will also be acknowledged in this chapter. Chapter 4 is dedicated to an analysis of the data. Chapter 5 presents an interpretation of the results of the research. Chapter 6 will deal with the overall conclusion and possible recommendations.

CHAPTER 2

LITERATURE REVIEW

2.1 Objective

The objective of this chapter is to review the theory of interest rates and provide a broad insight into the principles, controversy and problems of interest rates, particularly on small businesses. The literature available on the issue is extensive, and it is beyond the scope of this presentation to cover a critical analysis of all aspects. Therefore the focus is directed to small business activity.

In Section 2.2 the need for finance is presented. The interest rate debate is outlined in Section 2.3. Section 2.4 deals with the level of interest rates and its effects in the communities. The following section, Section 2.5 presents a discussion on interest rates and local economical development. The next section, 2.6 is about lenders' and borrowers' perspectives around the interest rates debates. Section 2.7 deals with the geographical distribution of lenders versus borrowers. The informational problem is discussed in Section 2.8. The general problem of high interest rates on a global scale is presented in 2.9. And in 2.10 is dedicated to an analysis of how to avoid business failure. Section 2.11 concludes the chapter.

2.2 The need for finance

In developing countries, where labour is in surplus and capital is scarce, some efforts have been made to develop programmes to assist small-scale enterprise (Harper, 1984, p.47). Because of the scarcity of capital, which is available it should be deployed as efficiently as possible in order to maximise the creation of new jobs and produce new goods and services.

Many enterprises, for example, need to remove critical constraints such as the lack of tools, or shortage of raw materials that prevent the economic use of a larger part of the resources employed. Because of the shortage of capital, the need for borrowing is an issue of great importance, which enables the development of small-scale activities.

Borrowing usually implies that there is an interest rate to pay. The interest rate is the price of money. Lingard G. (in Hull, 1986, p.4) explains this issue saying that "the recipient of the finance, if a firm, could use it in the operations of a business enterprise; if a bank could relent it; or if a government could use it to fund some state organised activity such as a road network. In turn, the providers of finance will be rewarded with interest or profits or both."

According to Fisher (1954, p.13) "The bridge or link between income and capital is the rate of interest." Accordingly, it is critical to examine how important this cost is to small borrowers and how valuable it is to them at reduced interest rate. Harper (1984, p.47) argues that "if the intention is to help small enterprises and in some way to compensate for the disadvantages inherent in their small size, it is natural to suggest subsidised rates of interest. It is administratively simple, politically demonstrable and attractive, and small businesses are genuinely assisted, because they have to pay less for a resource for which larger enterprises have to pay more."

Yet, on the other hand, Harper (1984, p.50) points out that, "from the lender's point of view at any rate low interest rates lead to excessive demand, unenthusiastic management and reduced competition." Here, he means competition among borrowers to access finance. Burkett (1997, p.4) concurs with this analysis and argues that "restriction of interest rates on loans causes excess demand for credit, and financial intermediaries respond by rationing loans to different classes of borrowers on the basis of the expected profit rate on loans to each class. Intermediaries can ration loans either through limits on the amount lent to different classes or by charging implicit interest (increased fees, paperwork, etc.) to borrowers."

Regarding the issue of the rate of interest, Fisher (1954, p.325) says "interest plays a central role in the theory of value and prices and in the theory of distribution. The rate of interest is fundamental and indispensable in the determination of the value (or prices) of wealth, property, and services."

The wealth, property and services exist in the household and business environment where a credit market is in place. Henwood, explores the relationship existing in the credit market where the interest rate is going to affect it. He concludes that, "in official mythology, the credit markets exist to collect the savings of households to lend to businesses that need other people's money to make productive investments that allow them, and the whole economy, to grow. In some deep sense, this may be true; debts are claims on future growth in incomes, and under capitalism, the principal engine of growth is investment by non financial corporations" (Henwood, 1997, p.60)

If we consider the South African context where households are of low income the extent of the credit market to collect the saving is questionable.

However, "it must be acknowledged that it's a bit misleading to focus on debts without taking note of assets. On debts alone, households, for example, are deep in the red but households also have assets like durable goods, houses, mutual funds, and stock in incorporated businesses (Henwood, 1997, p.60).

South Africa doesn't have enough savings to satisfy all its borrowers. So what can we do? One important way is to ask countries in a condition to lend their saving. Henwood (1997, p.61), mentions the case of the U.S. saying "in order to consume more than it produces, and invest more than it saves, the U.S. has gone deeply into hock abroad. Another way of looking at this is that the U.S economy hasn't generated enough of a financial surplus to satisfy all its borrowers, so it's turned to countries that have, like Japan."

Henwood (1997) presents a very interesting example on the need for borrowing. Answering the question why do you borrow? He argues that:

> "Robert Poliin (1990) concluded from a study of the SCF that the bottom 40% of the income distribution borrowed to compensate for stagnant or falling incomes (what Polin called "necessitous" or "compensatory" borrowing), while the upper 20% borrowed mainly to invest (or speculate, if you prefer). Pollin's findings find an echo in the British experience. A survey of that country's households concluded, " credit fulfils two roles in household budgets. Poorer families, on the whole, use credit to ease financial difficulties; those who are better off take on credit commitments to finance a consumer life-style. Both would use it to improve their lot: one to reduce their poverty; the other to increase their prosperity" (Berthoud and Kempson 1992 in Henwood 1997, p.65).

Henwood (1997, p.65) continues to say, "economically, then, consumer credit can be thought of as a way to sustain mass consumption in the face of stagnant or falling wages. But there has an additional social and political bonus, from the point of view of the creditor class: it reduces pressure for high wages by allowing buying goods they could not otherwise afford. It helps to nourish both the appearance and reality of a middle-class standard of living in a time of polarisation."

The need for finance varies according the purposes for what the capital is needed. We can distinguish, therefore, finance for consumption and for productive purposes. Then we have consumption or personal loans and business or productive loans respectively. Consumption loans are those ones for personal purposes. They come because of misfortune or improvidence. This kind of loan includes "sickness or death in one's family, or losses from fire, theft, flood, shipwreck, or other unexpected causes, make temporary inroads upon one's income. It ekes out the inadequate income of the present by sacrificing something from the more adequate income expected in the future" (Fisher 1954, p.357).

In general, consumption loans are for a short term with higher interest rates. Short-term loans are also suitable for providing working capital to support the normal trading operations of the business, particularly in its early years. This type of loan appears to be the most common kind of loan offered by cash loans (mashonisas) and by NGO's acting as micro lenders in South Africa.

The are other classes of personal loans that "derive from irregularity and unequal instalments, while their money outgo may likewise have an irregular time schedule" (Fisher, 1954, p.357). In this case, the person borrows to recover his level of income

Business loans, also called productive loans are, those dominated by the principle of "investment opportunity". This means that it is oriented by the possibility existing in the market to invest in certain place and in certain period of time. Loans for productive purposes are in general related to medium and long terms. This is for the purchase of equipment or another specific type of capital expenditure. This means that it is not for operation purposes in businesses but for investment. Although there is difference between business and consumption loans are that they are usually both contracted to rectify the distortion of the income stream that would otherwise result from business operations (Fisher, 1954, p.359-360).

Going further to the above argument in relation to the differences between business and consumption loans one can be pointed out that while personal loans are not for investment but to remedy or prevent a present dearth of income because of illness or the desire to anticipate future income, the productive loans are for remedy or to prevent a dearth of present income because wishes to invest and increase future incomes (Fisher, 1954, p.358).

The literature suggests that short term funding is the provision of finance for a short period (even 24 hours) but would rarely exceed six months. Short-term loans focus on the cash flows connected with the operations of a firm. It means that it is connected with financial impact on the firm within a short time (less than a year). Long term means ten years or more. Medium term funding refers to the provision of finance for any period between the short term and the long term (Fisher, 1954, p.370).

The effect of the type of loan has different projection on different type of borrowers. The simulated case presented below is an example of the difference between the type of loans. It was adapted from a example presented by (Fisher, 1954, p. 365).

Example 1: Personal versus business loans

> Let us consider the situation of a personal borrower because of illness and a business borrower because of investment. Let us assume that the two borrowers have a prospective income of R8 000 for the present year and R10 000 for the next year before they receive the loan.
> If both borrowers borrow R750 this year with 10% interest, the total repayment next year will be R825 (R750+R75) for each. Then the adjusted income for each borrower will be R8 000+R750 or R8 750 for this year and R10 000 - R825 or R9 175 for next year. This means that the income streams in the two cases are identical. The difference is that the personal borrower if he does not receive the loan will be affecting his lower income for this year that is R8 000, despite his higher income next year because of the interest. The business borrower, if does not receive the loan, has a chance to easily give up on the investment. We can observe that the latter has an option that the first does not have. For the first is matter of strong need but for the second is a matter of investment opportunity.

This situation determines specific behaviour that led to distinguish different approaches to lenders. This justifies, in some sense, why many personal borrowers approach cash loans to solve their immediate problems although they have to pay high interest.

Thus, there is a need to understand how important the role of interest rates in relation to financial needs and then to understand why many personal borrowers approach different lenders to get loans with different level of interest rates.

2.3 The interest rates debate

The perspectives put forward by various authors indicate that the interest rate issue is a very controversial matter. Some authors argue against and others in favour of lowering interest rates. For example, Harper (1984, p.47-48) declares that "capital is of course a need, but if its price is artificially lowered below the prevailing market figure, this will tend to encourage borrowers to use more of it than they would if it was more expensive. Demand will also be increased; the effect of low interest will thus be to attract a larger number of applicants, but to satisfy very few of them. The tendency will be towards a small number of relatively capital intensive enterprises, and a larger number of frustrated applicants who receive no help at all. Alternatively, the available funds will be evenly spread over a large number of applicants, so that no single borrower receives what he needs." One can argue, that at least it is better to have little than nothing.

According to Burkett, neo-classicists argue that, "because money is fungible, subsidised credit is an inefficient instrument for influencing resource allocation. If flows of funds respond to relative profit rates in different sectors, then funnelling cheap credit into a low profit sector (small scale agriculture, for example) is unlikely to increase investment in this sector. Without reversal in relative profit rates, subsidised credit targeted toward the low profit sector will move towards other investments yielding higher profits, by way of the credit rationing operations of financial intermediaries and self-interested investment decisions of borrowers" (Burkett, 1987, p.3-4).

An additional comment (Harper, 1984, p.48) regarding the effect of interest rates reduction is that "whenever the price of a commodity is artificially reduced below the market level, demand exceeds supply and the market price tends to reassert itself through 'fees' corruption or other 'costs' that must be incurred in order to obtain supplies." This point of view discourages policies intended to reduce interest rate levels. This argument is contrary to various authors who advocate for lower interest rates to enable small business growth and consequently local development.

Burkett (1987, p.13-14) quotes Miliband examining the role of Import Substitution Industrialisation (ISI)-oriented regimes on subsidised credit. He suggests the state as the main social driving force. He argues that "such a government's main goal is to ensure domestic stability which is required for the continued enrichment of state bureaucrats at the expense of society. Although this 'process of enrichment' which 'assumes a great number of forms and leads to a proliferation of diverse economic ventures' may result in the formation of 'a genuine local bourgeoisie,' this local bourgeoisie generally has continuing close connections to the state and its leading members, who are themselves part of that new bourgeoisie" (Miliband, 1977, p.108 in Burkett 1987).

The precept of the present study is whether there is a need for interest rate ceilings for small enterprises and if the levels of interest rates affect business and communities. How then, do the above arguments apply to this idea? Harper's argument, for instance, seems to be more concerned with larger enterprises. The argument of the author of the present study is however that, in the case of small enterprises, low interest rates may provide a basis for spreading small business activities because of openness to access capital, as they have to pay less for the money borrowed.

However, this effort is reduced because of the circumstances that in the South African countryside in general there are no banks were borrowers could transfer their savings. Rasmussen (1990, p.122 in Bond 1998, p. 312) highlights this aspect when he argues that "the people's and enterprises' dominant relation to the commercial banks is as savers, receiving only low interest rates, while the money saved is transferred to the city and then lent to larger enterprises." Lack of banks in rural areas allows money to go out of the geographical environment where the money is produced and thus it is not saved in the area. Consequently the money does not circulate in the community in the area and then does not contribute to circulation of resources within saver's environment.

As mentioned earlier, efforts to develop small business activities have been taken in many countries. However, some small business lending schemes fail to lend the funds they have available because of high interest rates. Does this not disprove the foregoing arguments? Such schemes have in fact created a barrier of appraisal procedures in response to the overwhelming demand, so that very few enterprises can qualify. Even if the loan is approved in principle, the controls are so strict that funds, once committed, cannot be disbursed. For example, the case of Zimbabwe is similar to the South African one: "the Zimbabwe banking system is 'too rigid', formal and too insensitive' to the majority of peasants who contribute substantial sums of money to banks in the form of deposits but are unable to borrow" (Herald, 1990, May 12, in Bond 1998, p.312).

Harper (1984, p.50) suggests that "the supply of funds must depend on Government grants, foreign assistance or other unreliable sources which are insensitive to demand, since the interest rate is not high enough to encourage local people to deposit money with the lending institutions and more people who deposit will want to borrow money than can be accommodated. Businesses which receive loans are likely to be those nearer to the maximum level scale, however defined, which has been laid down as a condition of eligibility, since they can afford time, the bribes, the administrative procedures and the travelling expenses which must be expanded before a loan is obtained. They are likely to be those least in need of assistance."

From examining the literature, it becomes apparent that there are many reasons for the high rate of arrears experienced by most institutions lending to small enterprise. But low rates of interest are often involved. The argument is that when a borrower has to decide when to repay a loan, the interest rate seems to be the only variable, since the principle will not change. If the penalty for delay is modest and particularly if it is well below the prevailing rate of inflation, the incentive for delay is obvious.

However, there is an argument that "high rates of interest will not automatically remedy all problems of arrears, but they have some influence on borrowers who can repay, at some sacrifice, and who cannot effectively be forced to repay" (Harper 1984, p.49).

One example of the situation presented above is from Nigeria. The Nigerian State government set up special departments to operate a small industry loan scheme since they were aware that the commercial banks were unwilling to make medium or long term loans at low rates of interest to small businesses. After the initial allocation was lent, no more money was available from this source. The borrowers delayed the repayment as long as possible, since the interest rate was well below half the prevailing rate of inflation in the country. Government staff is also reluctant to take departments to court or to seize securities, to avoid the potential loss of the political goal this would cause. As a result, many of the small business loan schemes ceased to operate because the money which, had been lent was not returned for further lending. Banks or other private lenders on the other hand were even less enthusiastic than before, because the higher interest rates they charged would have appeared severe in comparison to the rates widely published and charged by the Government (Harper 1984, p.48).

Henwood quotes Stilgitz and Weiss (1981) focusing on credit markets, arguing, almost entirely in mathematics to discuss the in'erest rate issue. They say that at a given interest rate, lenders will earn lower returns by lending to ad borrowers (because of default) than to good borrowers. If lenders try to jack up the interest rate to compensate for this risk, they may chase away good borrowers, who are unwilling to pay a higher rate, while perversely not chasing away incompetent, criminal, or malignantly optimistic borrowers. Such a market is not clear; there will always be unsatisfied players at a given rate of interest. Sliglitz and his collaborators (Greenwald and Stiglitz 1984; 1987; Stiglitz 1988) argue that informational problems explain credit rationing, which in turn can explain both the business cycle and unemployment (Henwood 1997, p.172).

Henwood (1997, p.173) explores the case of Great Britain. The example produces much insight on the issue of the level of interest rate. He comments that "if the legal rate of interest in Great Britain, for example, was fixed so high as eight or ten percent, the greater part of the money which was to be lent would be lent to prodigals and projectors, who alone would be . .lling to give this interest. Sober people, who will give for the use of money no more than a part of what they are likely to make by it, would not venture into the competition. A great part of the capital of the country would thus be kept out of the hands that were most likely to make a profitable and advantageous use of it, and thrown into those which were most likely to waste and destroy it."

A important argument about the level of interest rate in relation to the household is highlighted by Henwood saying "changes in interest rates do affect the finances of households and business; rising interest rates will divert funds away from real spending and towards debt service, while falling rates can deliver a windfall. One shouldn't make too much of this; in a strong expansion, rising employment, incomes, and profits will probably outweigh a modest increase in interest rates, and in a deep slump, low rates can be only a weak antidote to the general economic despair" (Henwood 1997, p.121).

Let's now consider in this discussion the influence of cultural aspects on the perception of the effect of interest rates. Indeed, cultural aspects do affect the way borrowers perceive loans and consequently about the interest rates. This affects whether people will be prepared to pay interest on their loans. Kiiru & Pederson (1997, p.29-30) analysing the case of the Kenyan Woman Finance Trust (KWFT), realise that some groups of credit do not properly understand the implications of a loan and confuse it with grants received from donors and the government. Also they realise that "Islamic faith does not approve of paying or receiving interest. Paying interest is considered unjust, and KWFT has only managed to circumvent this obstacle by putting it as charging expenses related to loans, rather than interest per se."

This presentation demonstrates the complexity of interest rates and highlights the need to look on it in a dynamic and flexible manner.

2.4 The effect of an interest rates level in a community

So far, some arguments have been presented about the level of interest rates. It is necessary also to look at another perspective that encompasses not only the impact of interest rates on borrowers, but also the effect on the surrounding communities.

The interest rate level has the power of enabling some circulation of resources in a community. Cheaper interest rates tend to improve the possibility of gaining access to capital, especially among the disadvantaged and impoverished. Without cheaper interest rates, expansion of business to communities becomes narrow and practically difficult. Hull (1986, p.70) argues those "credit facilities for local enterprises have been greatly expanded in a conscious effort by the state to develop domestic capital." In Indonesia, for example, "the main form of subsidies is low-cost rediscount facilities from the Bank of Indonesia for loans made under government programmes. Thus, the Bank is not forced to go to the market place or pay market rates for their funds. They simply lend at the rates mandated by the various government programs" (Hull, 1986, p.72).

According to Kilmer, (in Kiiru & Peterson, 1997, p.8) referring to the example of Kenya, programmes with credit facilities for local borrowers have been very effective in transferring large amounts of investment funds to small scale entrepreneurs. This led to business expansion in these communities.

Business expansion to communities causes a 'multiplier effect' that results in a progressive advantage to community development. This perception is also asserted by the ANC (1994) report which, states that to foster the growth of local economies, broadly representative institutions must be established. He continues saying that their purpose would be job creation and community development. In addition it states that, if necessary, the democratic government must provide some subsidies for job creation programmes controlled by communities and/or workers, and target appropriate job creation and development programme in the most neglected and impoverished areas of our country (Cashdan, 1997, p.3).

Brown in discussing the role of banks and the issue of subsidies, indicated that "banks are overcoming their fears and finding ways to make such loans at acceptable costs, for whatever economic and political reason" (in Hull, 1986, p.68). The key to a successful program, he believes, is the commitment to undertake small scale lending in a big way. Although the risks seem to outweigh the advantages initially, Brown contends that "the case studies show that small scale lending to businesses can lead to substantial new markets and eventually to profits" (in Hull, 1986, p.68).

A new market lets the money circulate in the community. There is an attempt from the some communities to keep money circulating in their environment. This attempt is through savings process which Bond calls Savings Clubs. In fact, savings clubs appeared to be one of more successful means of saving in rural areas. It can be informal and formal clubs with different levels of organisation, employees and religious affiliations. The basic procedure of these 'institutions' is the contribution of a certain agreed amount and then "at each meeting one member is paid the entire amount saved by the group over that period" (Bond, 1998, p.313).

An interesting point about clubs is that they express the willingness of people to look after their own affairs. In addition Chishawasha Mission (1967, p.5 in Bond 1998) states that the savings and credit clubs could contribute "to the building up of social and individual moral character."

Saving clubs express the effort emerging from the community to make sure saving takes place. This constitutes a specific way of lending inside a community. This situation is a great indicator of a sense of initiative and a sophisticated perception of the process of capital accumulation, albeit at a grass roots level. But the fact that banks are located out of the community means the savings are benefited by others who can access bank loans outside the community. However attempts to give a formal structure to this kind of initiative is not easy and some experiences show how this is difficult to implement. For example, in Zimbabwe, savings clubs attempted to evolve from simple savings into credit unions in the 1960s and 1970s with support from church groups, university researches, and commercial producers and retailers of agricultural inputs. Nevertheless, these credit unions failed because of limited capacity of the savers to handle credit matters. Also because of erratic member participation and excessive absenteeism (Bond, 1998, p. 314).

To avoid any misperception, it is important to stress the important role of the savings clubs in rural areas as a way of income generation for household finances and, particularly, as a base for aid for women in the post independence era in Zimbabwe (Bond 1998, p. 315).

There are, yet, in the literature, many arguments against the approach of cheaper interest rates. This is because, in general, credit is available and many people access it. For example, quick loans in South Africa, are available at a high price achieving up to 300% annual interest rates. It can then be concluded that people can afford to pay high interest rates. This is not true. Only some can really afford to pay without facing collateral problems.

Harper (1984, p.47) mentions the inflationary consequence, among other problems, as an argument to be considered opposing cheaper interest rates and favouring high interest rates.

Bond mentions (Reynnolds, 1987; Rasmussen, 1990) advocating "the rapid growth of community-based credit unions even under such usurious lending terms, which is consistent with a positive view of high interest rates in the international literature based on the notion that high rates force higher levels of productivity, mitigate against the tendency to "distort" financial markets through below-market rates, and enhance cost recovery" (Fry, 1980; Galvis, 1982, in Bond 1998, p.317).

Going further to this controversy (Beckerman, 1988; Burkett and Dutt, 1991; van Wijnbergen, 1983) indicate that " there are, in contrast market orientations reasons for avoiding high interest rates: the relative pricing of financial assets becomes distorted to the disadvantage of productive lending, and household liquidity preference under conditions of uncertainty is also damaged" (In Bond 1998, p.317).

This argument concurs with the argument that if raising inflation to a certain point will enable access to resources and thus create conditions for subsequent community development, why not consider it? This will result in the creation of more small activities in communities and consequently more job creation opportunities. It is, in effect, a matter of trade-off between inflationary effects and community development.

The access of resources in a community will result in increasing productive activity and in the long run, will reverse the inflationary situation and thus establish the economic environment with an acceptable inflation rate. However, in the process it is necessary to be aware of the effects of externalities. Whenever externalities conditions are stabilised in a certain community, members of other communities will be attracted to move to the community in focus. Although this can be seen as a problem in one way, the situation can also be used to address uneven distribution of resources and services between communities. The consequence then, could be that new localities begin to produce revenue that was not possible to generate before and consequently reduced the need for national transfers to meet local needs.

Hence, this approach can be viewed as a way of bringing about development in the community in particular, and at a national level in general. This perspective is highlighted by Cashdan (1997, p.3) that "municipalities now form a distinctive sphere, with a mandate to govern, to provide services and to promote social and economic development. These responsibilities require each local authority to develop distinctive policies aimed at meeting the particular needs of its communities."

This situation generates a degree of competition between communities and thus promotes efficiency and initiative. This is sound when, in addition, it is supported by co-operation between communities through exchange of information, consultation and co-ordination on matters of common interest. One can propose then, that this will be a useful task to strengthen economic development.

Interest rate levels tend to impact not only on borrowers, but can also be used as a way to promote change in the geography of production and on local labour markets. It is to be anticipated that traditional areas of production which lose manufacturing jobs could be replaced by new areas of production in the country, even if it is with lower-wage job opportunities.

This will help to increase access to jobs and thus compete for poverty alleviation. This asks for suitable policy intervention from the state.

Burkett (1984, p.8), in relation to the impact of interest rates, indicates that in a "Marxist view, financial development and state financial policy should be analysed in terms of development of class relations in the competitive dynamics of capital accumulation and the functions of state policy in providing those conditions for accumulation and financial development that cannot be generated by competing capitalist firms" For example, Hull (1986, p.66) indicates that "in cases where there have been successful attempts at small-scale lending, such as in India and the Philippines, government policy has provided a stimulus. Some governments have required that a certain percentage of the value of loan funds be utilised for development purposes." This is in contrast to the neo-classical view, which analyses financial development and interest rate policy by the level of supply and demand forces, without investigating how class relation shape these market forces through their development in the process of capital accumulation.

Thus, the development of class relations in the process of capital accumulation increases the profits that can be appropriated through the mobilisation and allocation of funds. Financial intermediaries appropriate these profits through the difference between the interest paid by borrowers and interest payments to savers, minus interest on the capital invested by the banks themselves. The bank role in determining the overall rate of capital accumulation is crucial, because it is the banks that mobilise idle funds and allocate these funds among competing firms, including those firms (the banks) operating in the financial sector (Burkett, 1984, p.9).

Countries like Japan and Germany that are usually classified as bank centred - because banks provide more outside finance than markets, and because more firms have long-term relationships with their banks - show greater growth in and stability of investment over time than the market-centred ones, like the U.S. and Britain. The reason seems to be that British and U.S. firms are more dependent on their internal funds for financing investment, in contrast with firms in the other countries, where outside finance is available from a familiar banker. Further, studies comparing German and Japanese firms with tight bank ties to those without them also show that firms with bank ties exhibit greater stability in investment over the business cycle (Corbett and Jenkinson, 1993; Elston, 1994; in Henwood, 1997, p.174-175).

The above presentations make it clear how important the Reserve Bank policies are in the issues under discussion.

In debating the role of interest rates on borrowers and on the community, the understanding is that by enabling the spreading out of small business activities, communities will consequently gain by subsequent activities appearing to support the small business. This approach promotes the general economic health of the community and reduces its dependence on central governments. In addition, this strategy will contribute in resources to public spending and reduce public borrowing. This argument is enriched by Cashdan (1997, p.5), who expresses that "at the same time the prevailing wisdom in many national governments was to reduce state spending in order to encourage private enterprise. Reduced public borrowing would keep down interest rates and inflation, stimulating private investment, creating jobs and wealth."

The contention of the interest rate and implication on local development fits into the overall debate on the way national government should act to support local economic development. In discussing this issue, it is appropriate to look at the suggestion of Cashdan (1997, p.44) which states that "national funding for community development organisations is an important contribution. National government should examine the possibility of using the tax code, or banking regulations to make funds available to community groups. In addition, intermediaries like the National Development Agency (NDA) should be strengthened. Provisions should be introduced to ensure those enterprise support bodies, like Khula & Ntsika, are able to support community-based groups."

The concept of local economic development makes a great contribution to the redistributive process by increasing the tax base in the localities. It spreads redistributive burdens across everyone who pays income tax and VAT by productive activities in production and service areas; it enables any source of money to pay income tax (Cashdan, 1998, p.45).

Clearly, one way of addressing this problematic issue is to direct efforts to increase activity in those areas of communities that will result in greater tax revenues. This approach would be more advantageous than looking only at intergovernmental transfers.

A good example to mention in addressing this kind of situation is presented by the FFC. It says that equity means that certain minimum levels of service provision must be attained for all citizens. For example, the absence of clean water or inadequate sanitation, leading to disease, would clearly affect not only those too poor to afford those services, but would also expose other members of the communities to the danger of infection. In their interest, the relatively rich communities should ensure that the poorer neighbourhoods receive sufficient services to meet the minimum standards. This they should do, if necessary, by subsidising the levels of service consumption in their vicinities (Cashdan, 1997, p.9).

Most communities in South Africa are located in rural areas. The situation in rural areas does not escape the influence of national and international economies. The level of prices in agricultural exports, for example, varies according to the national policies adopted and international markets prevailing. Also, the influence of neighbouring towns on rural livelihoods is that changes in urban economies will affect rural areas. Another important aspect to point out is related to land ownership, which is vital to rural economies. Cashdan (1997, p.13) states that "it is hoped that the land reform programme will help to enhance rural livelihoods."

Commenting further on the local development perspective Cashdan, (1997, p.14), has indicated that:

> "The message to local authorities in South Africa is clear. Changes in the global, national and local economies may have profound effects on your communities. Local industries may decline and workers may lose their jobs, or move from some formal employment to part time or causal positions, losing either income or benefits." "In addition, national policies and programmes will have impact on your economy and on the resources available to you. With your new constitutional mandate you have a responsibility to attempt to make sense of your economic circumstances and to develop policies and programmes which you believe will help your community. Your objective should be balanced development. In other words, your efforts at promoting growth and attracting investment should be linked to reducing inequality and tackling poverty."

The above presentation concurs with efforts in many countries to restrict interest rates in an attempt to alter the internation , division of labour in favour of domestic capital as Burkett mentions. He also indicates that "the uneven development of capital accumulation on a global scale has inhibited industrialisation in the Third World, and this has not stunted the financial development process, ... but has also eventually led to inaction of interest rates restrictions by the state" (Burkett, 1987, p.11).

This Research Report will argue that, by having cheaper interest rates, it is possible to deal with the problematic issue ented above related to local economic development. In supporting t. sertion, some analysts argue "there is also growing evidence of the extent to which many successful producers are 'embedded' in the local economy, tied into social and cultural networks (Piore and Sabel 1984, Harrison 1992, in Cashdan, 1997, p.21). For example, Japanese automobile plants pioneered 'just in-time' manufacturing, where a large number of small supplier's cluster around the main plant, providing inventories as required. This relies on a network of close relationships, based on trust and co-operation. Not purely low costs. Social and cultural networks have similarly been identified as the basis of innovation in the textile industry in little Italy. Many municipalities have tried to nurture these networks of local innovation, through business 'incubators' that provide credit and training and support for research & development (Cashdan, 1997, p.21).

An argument to flesh out here is the need to encompass decisions on interest rates with social measures in the community.

2.5 Interest rates and local economic development

In essence, there is a common agreement on the need to improve local economic development. However, internationally there are various approaches and interpretations on the very concept of local economic development. Some of these approaches mentioned by Cashdan, which are appropriate for our discussion are outlined here:

Entrepreneurial-Competitive Strategies: This emphasises the importance of local comparative advantages and small businesses in job creation. Local authorities play a proactive role in identifying actual or potential growth sectors and in directly supporting local businesses through research, loans, grants, consultancy, premises, technical infrastructure and so on. Municipalities have engaged in research to identify the particular economic strengths of their locality, and some have even produced a local industrial strategy (Cashdan, 1997, p.23-25).

Community-Based Strategies: This approach emphasises the importance of working directly with low-income communities and their organisations. Investment is all very well, but the benefits are unlikely to accrue to the most needy unless they are active participants in new development, with the capacity to plan, monitor and enforce wider benefits (Cashdan, 1997, p.23-25).

The Progressive Approach: This system aims explicitly to link profitable growth and redistributive development. An example of the progressive approach is a requirement that banks or other financial institutions opening a branch in an area must invest a certain proportion of their turnover in local small businesses. Where banks are hesitant to open branches in low-income areas (such as many townships), municipalities have been known to make such branch openings a condition of access to municipal funds and accounts. Over the past few years, several municipalities in the United States have introduced *living wage* legislation at local level, to outlaw exploitation (Cashdan, 1997, p.23-25).

Is not easy to establish which one of the approaches prevails in South Africa. But one can assume that a mix of them has been experienced. Time will determine the appropriate one. These approaches to local development are important because of the way financial institutions must address the lending process in communities.

Clearly, low interest rates may promote redistributive development because businesses have less to pay for the money borrowed. This view competes with our earlier suggestion, to consider a certain level of inflation if it enables access to resources.

In the initial discussion, the neo-classical and Keynesian schools of thought were entertained as two contrasting approaches to development. The neo-classical analysis argues for deregulation of the financial market, while on the contrary, the Keynesian perspective advocates for regulation of the market.

As mentioned previously by Harper (1984), (Fry, 1980; Galbis, 1982 in Burkett, 1987, p.15) also examines the implications of the interest rate ceilings that are connected to the regulatory system according to neo-classical view. The neo-classical critique the financial regulation framework, particularly what they call financial repression, saying "loans are transfers from one economic agent to another agent, as mediated by banks and other financial institutions. If interest rate ceiling causes a lower return on financial assets, a decreased supply of savings will result. The amount of savings available for investments will decrease because of the lower level of savings mobilisation by financial intermediaries".

Burkett goes further by saying that in the neo-classical view, interest rate ceilings have a regressive impact on income distribution. Such ceilings depress the real return on bank deposits and this will have a greater impact on the incomes of poorer households who lack access to the alternative assets (real estate, foreign exchange, etc.) which are available to wealthier households. If real interest rates on bank deposits are repressed to negative levels, the poor are forced to save in the form of inflation hedges (real goods), which often involve high storage and transaction costs (Burkett, 1984: Charp. 3, in Burkett, 1987, p.3).

Evidence suggests that the deregulation of the financial sector, particularly the removal of the interest rate ceilings laid down in the Usury Act is not, per se, the appropriate response for development. It is important to have interest rate ceilings, or better, flexible interest rate ceilings facilitate business access to capital. India provides the most compelling example on small business programmes where millions of loans have been made to date, almost entirely due to government policy. Larger programmes exist only where there were clear incentives at the beginning (Brown in Hull, 1986, p.67). Flexible interest rate ceilings are also a factor that contributed to the success of the programmes

Burkett's work views the neo-classical argument of deregulation as very optimistic and a way to facilitate economic growth as well as development in Third World countries. For him, the "excessive optimism stems from the failure of neo-classical theory to relate financial development to: (1) the development of class relations in the process of industrial capital accumulation and (2) the competitive dynamic of capital accumulation, including the concentration and centralisation of capital and the uneven development inherent to the accumulation process" (Burkett, 1987, p.1).

Fine and Rustomjee (1996) concur with the above view, in their book, "The political economy of South Africa". They describe in detail how the process of accumulation in South Africa, as well as the concentration and centralisation of capital has developed. They describe it based on an exploitation of the labour force through low wages, which resulted in uneven development.

They argue for a new methodological approach to enable a new understanding of the apartheid regime, and the economic and political structure prevailing in the system. Their focus is on the formation of a class structure based on state intervention. They also point to the problem of race and class as an important aspect in the development of class relations in the process of industrial capital accumulation based on the concepts of Mineral Energy Complex (MEC), where linkages (economic process) and agencies (active role players) are identified as paramount in that process of accumulation (Fine & Rustomjee, 1996).

According to Henwood (1997, p.66) "wealth is now the most concentrated it's been since the 1920s". For Edward Wolff (1995, pp. 28, 62-63), "this trend is probably the result of several things, among them the increasing 'dispersion' of wages and salaries-economists prefer this morally neutral term to the more value-laden 'inequality' which has depressed saving among the middle class and boosted it among the rich. Also the relative stagnation of house prices (the main repository of middle-class wealth) along with the phenomenal rise in stock and bond prices from the early 1980s through the mid1990".

Fine and Rustomjee (1996) suggest that the role of the state is a crucial factor in economic development. The state is especially important in industrial policy in defining lines of development and more empirical data is necessary to understand the different economic interests within the capitalist class in the South Africa arena.

Therefore from the discussion it is important to comment on the present effort towards black empowerment that is based on some concentration of capital, at least at this first stage. This can be one important way to address the problem of class relations in South Africa. However whatever the concentration of capital, without a redistributive approach in life conditions in the community will not be altered. So the concentration of capital is not positive per se, but it can be, when viewed in a sense of a base for a distributive way of capital in the communities.

Henwood arguing about the problem of class relations suggests that:

> "despite myths of affirmative action and upward mobility, the tendency of wealthy to concentrate, for advantage to breed advantage, makes it hard on people who start with nothing. Quite surprisingly, economists do not really have a very solid idea of what share of personal wealth comes from savings during individuals' lifetimes, and what share is inherited. This is in sharp, a contrast to the reams of studies on the 'intergenerational transmission of welfare dependency'. Estate taxes, a possible source of information, are widely evaded; also, surveys of the wealthy are rare, and any answers they elicit would have to be taken with a grain of salt" (Henwood, 1997, p.68).

Another important aspect to be considered is taxation policies. This plays important role in economic development. Beare (1993, p.164) states that:

> "a government has available to it a wide range of instruments with which to achieve its economic objectives, including fiscal or taxation policies. Taxation can be split between taxes on income and capital (direct taxation), such as income, corporation and capital gains tax, and taxes on expenditure (indirect taxation), such as VAT (Value Added Tax). These an other taxation policies can be manipulated, in combination with the use of other measures such as interest rates, in order to stimulate or curtail, for example, consumer spending or levels of investment."

A cross subsidises policy is one important measure to be considered to deal with many situations in South Africa. For example the case of electricity in Mamelodi to be mention later falls in this context. In fact, what seems to be necessary is the need for a different approach to the pricing process, which takes into consideration the need for the provision of, services to low income people. This approach has to go beyond a cost recovery policy. It is necessary "to consider a broader system of universal entitlements to basic services, financed through national, provincial or local cross-subsidies" (LEDEC, DDD, 1998, p.32).

The same document indicates that "even if the administrative costs of imposing a cost-recovery policy were lower, it still might not be wise in view of low levels of affordability. Nationally, according to an October 1996 government poll of South Africa's 878 local authorities (of which 525 responded) only 255 of total rates and services charges levied to resident was actually paid, with one third of the total bills consistently reflecting delayed payment or outright non-payment."

The situation is, in fact, complex and deserves special consideration unless it is to be faced with a cycle of non-payment and cuts. A specific investigation might give much insight to the issue. Nevertheless it is important to indicate that non payment is a result of "a combination of factors including poverty, lack of billing, disgust at the generally degraded state of most townships, the extremely high cost of transport (which is often the largest component of the household budget), broken promises of service improvements, alienation from white (or often black) local government officials, and so on" (LEDEC, DDD, 1998, p.32).

It is agreed that cross-subsidies is one of the greatest measures undertaken in South Africa situation where people face the problem of non-payment are those of very low income. Added to this is the fact that the constitutional responsibility indicates a need for the provision of a basic minimal amount of water/sanitation and electricity.

It is to support the view of a system of a free lifeline amount provided through metered taps and electricity with technical systems to reduce the amount to be consumed to the lifeline minimum in the event of no-payment on amount higher than that minimum, suggested in the LEDEC paper (LEDEC, 1998, p.33). This has to be undertaken with community involvement through civic movements to build a strong consciousness of government support. Otherwise they will settle on the perception of economic injustice and thus not collaborate with the government authority. It is reasonable to conclude that experiences show that the state has a significant role to play in local development.

2.6 Interest rates, lenders and borrowers perspectives

Continuing with the discussion on the impact of interest rates and trying to understand its scope, it is valuable to also look at some specific issues from a lenders and borrowers perspective.

2.6.1 Effect on the lenders

According to Harper (1984), "it is bound to be more expensive to lend small amounts of money to several borrowers than large amounts to fewer borrowers. The costs of provision, appraisal, disbursement, supervision and collection are not directly related to the amount of money lent and smaller, less sophisticated borrowers may take longer to appraise and require more skill on the part of the lenders because of the lack of the necessary financial data." If the risk of default and the interest rates are the same as for large and small borrowers, large loans will be more profitable. If the actual transaction costs are correctly calculated and charged to the loans to which they relate, it will be clear that large scale lending must subsidise lending to smaller enterprise.

Hull (1986, p.38), in commenting on this issue, mentions that "bankers point out that it often takes a lot more time and effort to determine the creditworthiness of a small business than of a major corporation. More paperwork is involved, especially if the loan is guaranteed by the Small Business Administration. The income earned on a small business loan, even at a high rate is small compared with that earned on a big loan. Banks have often increased their fees to cover the cost of services. However, a small business that manages to maintain a high enough balance in its checking account may escape paying direct fees."

A major problem in the relationship between small business and their bankers is that the entrepreneurs do not fit easily into the corporate modes established by the banks. From the banker's perspective, a business is expected to maintain records similar to those of large firms, a practice that many smaller firms find too time consuming. On the other hand, the small businessperson looks for a personal relationship in which the banker understands the basic problems of his or her business.

The Consultative Group to Assist the Poorest (CGAP), trying to establish the relation between bank and borrowers make an exercise in two directions. The first direction is in bank side and the second is in borrower side presented later.

In the first direction, CGAP question if Micro-Finance Institutions (MFI) should charge high interest rates? Answering this question CGAP argue that there is evidence " that many poor people can pay, and therefore MFIs can charge rates of interest that are much higher than the rates that commercial banks charge to their usual customers. Moreover, it attempts to explain why this result is not particularly surprising. But given that MFIs can charge such rates, the question remains whether they should. Most MFIs are lodged in grant-funded non-governmental organisations whose overarching objective is helping the poor, not maximising profits. And while many poor entrepreneurs can pay high interest rates, it is also clear that some cannot, and are thus excluded from programs that insist on charging interest high enough to cover all costs" (CGAP, 1996, p.5).

The argument underlying the approach presented by CGAP is the need for sustainability to enable survival of the MFI and enable mobilisation of commercial funds to pursue its social mission. This approach from CGAP can be connected with the neo-classical school of thought that since 1970s, has promoted high interest rates as a policy to stimulate saving in less developed countries.

This argument is per se questionable in a South Africa context where in many communities people are so poor and therefore the majority of the people can not afford to pay high interest rates.

MERG (1993, p.252) arguing in relation to this problem of affordability of high interest rates say "empirical studies do not support the validity of such policies". The basic argument advanced by MERG is that the financial saving should attract positive real interest rates and should be a combination of monetary and exchange rate targets, and not based on personal saving as it is suggested by CGAP.

2.6.2 Effect on the borrowers

The purpose of low interest rates, apart from any political aspects, is to help small businesses' access to capital by lowering the cost of finance. It is necessary to examine how important his cost is to the small borrower, and how the reduced interest rate would clearly be preferable to a borrower than a higher one.

These factors influence the level of service provided to borrowers, so that application delays will be lengthened, and applications will be less likely to be successful.

The lenders, whether they are banks or individuals, are encouraged by high receipts to provide a wider range of services, and to reduce collateral requirements. "The remedy for this is not to prohibit private money lending, or to impose official interest rate ceilings that discourage people from lending, but to encourage as many individuals and Institutions as possible to enter the market for financing small business. Competition will bring down interest rates far faster than legislation (as it has already started to do in India and the Philippines)" (Harper, 1984, p.50-52).

Is it certain that competition alone will bring down interest rates faster than legislation? One can suggest that in developing countries, in particular, care must be taken in analysing these arguments. The legacy of the apartheid system in South Africa, where access to capital was based on discrimination criteria led to a specific view that legislation has an important role as a driving force to ensure equitable small business development. This is the same for Mozambique and many Southern African countries that are faced with uneven distribution of capital accumulation.

On the borrower side, trying to establish the relationship between borrowers and lenders, CGAP question if Micro borrowers can pay high interest rates?

They argue that "there is overwhelming empirical evidence that huge numbers of poor borrowers can indeed pay interest rates at a level high enough to support MFI sustainability. Informal credit markets already exist in most poor communities. One typically finds lower-income borrowers taking and repayment repeated informal loans at interest rates much higher than any formal MFI would charge." Although one can argue that this can be admissible if the interest rates are on short-term loans, it is questionable if many borrowers can afford it and if it is acceptable in development perspective (CGAP, 1998, 6).

2.6.3 Transaction Costs

On transaction costs, Harper (1984, p.52) argues that it is necessary to ensure that small business lending operations will be efficient for borrowers and lenders alike. It is essential to reduce costs for both the borrower and the lender. Borrowers need branches that are easy to reach and are staffed by well-trained responsible professionals who can assist them to apply for and rapidly receive loans. While lenders need to reduce their operating overheads and to rely on rigorous, centralised approval procedures which minimise mistakes arising from poor training or dishonesty.

Also, eliciting a properly prepared application, approving this and comprising legal title to any security may well take longer for a small, distant and unsophisticated borrower than for a well-known company whose staff are familiar with the bank and its requirements. In addition, it is said that small business borrowers often misapply their loans or mismanage their investment (Harper, 1984, p.52-53).

This situation calls for strong supervision of borrowers and to attach the funds necessary for repayment by arrangement with a customer of the enterprise. This takes a great deal of administrative time and money that is unnecessary for a large-scale borrower. Since the return is as interest on the sum borrowed and the rate of interest is very rarely higher for smaller borrowers than for large ones, it is clear why small business lending is unattractive.

Banks spend money on sophisticated appraisals of an applicant's data, often resulting in delays and requests for further estimates or guesses, all of which takes time that is expensive for the applicant (Harper, 1984; Hull, 1996).

This sophisticated appraisals can be perceived from t formula of interest rates extracted from (CGAP, 1996, August 1) and presented above. It becomes evident how the effects of transaction costs affect the interest. For higher levels of transaction cost, expressed on administrative expenses, the annualised interest rates become higher. This indicates that there are various factors concurring for the annualised effective interest rates.

$$R = \frac{AE+LL+CF+K-II}{1-LL}$$

R - Annualised effective interest rate

AE - Administrative expenses

LL- Loan losses

CF- Cost of funds

K- Desired capitalisation rate

II- Investment Income

- The administrative expense component of the interest rate: includes salaries, benefits, rent, and utilities. Depreciation allowance (provision for the cost of replacing buildings or equipment, training, technical assistance, management. Administrative expenses of efficient, mature institutions tend to range among 10% - 25% of average loan portfolio.
- Loan loss Rate: This element is the annual loss due to uncollectible loans. Many good institutions run at about 1-2%.
- Cost of Funds Rate: Future "market" cost of funds
- Capitalisation rate: This rate represents the net real profit the MFI decides to target, expressed as part of average loan portfolio (not of equity or of total assets).
- Investment Income Rate: is the income expected from the institution financial assets other than the loan portfolio.

2.7 The geographical distribution of lenders versus borrowers

The geographical distribution of lenders is an important issue to be examined because ‹ concentration of lenders in towns limits the money access and circulation. Thus bo› ›wers struggle to find credit without success in many cases. Kiiru & Pederson (1997, p.7) mention that "the lack of credit in rural areas represents a formidable problem, because are several barriers to building a durable rural financial market".

The concentration of lenders in town reduces the incentives for businesses to go to needy communities. Eisinger (19›8, p.175) stresses that "many business firms simply believe that needy community or distressed zones within otherwise healthy jurisdictions are particularly unattractive locations for investment". Commenting on this negative trend about lending where lenders are averse to spreading their activity towards needy zones, Eisinger has observed that "the small business sector is burned by market failure - the failure to allocate capital to its most productive uses - that prevents small business from realising its full economic development potential" Eisinger (1988, p.243).

Bond (1998, p.310) addresses the same issue in the Zimbabwean context arguing that "the geographical decentralisation of borrowers (relative to the concentrated location of financiers in the towns) is but one part of the problem. The spatial location of bank branches and related logistical features - such as the hours during which branches were open (a serious constraint to those travelling long distances to do business) and the cost of basic financial services - were supplemented by a geographical ebb and flow of funds that served not to develop, but to underdeveloped areas because they had little relation to the production process (itself suffering intensifying contradictions) and little relation to organic processes of social organisation".

Bond illustrates his argument, indicating that "in contrast, two thirds of commercial banks offices and 72% of building society branches were in these eight largest cities, with 9% of banks and just 1% of building societies in towns of 2,500 or less. To their credit, banks introduced mobile agency services to some areas in 1985, concomitant with the increased monetisation of the countryside banks to increased agricultural marketing and extension services. But, without nearby formal banks and offices, rural Zimbabweans were extremely limited in their ability to manage personal finances" (Bond, 1998, p.310).

The point in discussion here is about measures to assist disadvantaged locations where weak people live. However there are arguments against this kind of assistance. One is that "by strengthening the advantaged jurisdictions, it is possible to set in motion a trickle-down process that will ultimately benefit needy places" (Eisinger, 1988, p.75).

Because of the South African market conditions it is not appropriate to consider seriously Eisinger's approach because the balances of forces up to now tend to neglect the most impoverished people.

Among measures to help the expansion of lenders' services there are many approaches suggested. Among others Eisinger indicates "the more common is to make tax abatements and various capital subsidies-loans, loan guarantees, IRB financing- available only to firms that locate in areas of high unemployment or areas characterised by blight. A second focus is to make public works grants to local governments on the basis of economic distress as a way of helping the neediest jurisdictions to attract industry" (Eisinger, 1988, p.181).

There are other arguments about this issue. Harper (1984) indicates that "the performance of many enterprises, of all sizes, suggests that the scarcity of competent managers is a more serious constraint on economic development than the shortage of finance. Small enterprises are preferred because they use less capital that is a scarce resource; it may even be more important to promote them because they use less management, which is even scarce.

Hull (1986, p.38) arguing on this says "some banks that have geared up efficiently for small business loans that have become enthusiastic about the field, however. In some cases, these loans can actually be more lucrative than lending to bigger companies with more bargaining power".

Fisher (1954, p.29), presents another perspective on the role of interest rates. He says that "the problem of the role of interest rates is entirely a problem of spending and investing, of dividing between various possible enjoyments constituting income, especially between relatively small but immediate enjoyments and relatively large but defined enjoyments. There is an eternal conflict between the impulse to spend and the impulse to invest. The impulse of a man to spend is caused by his impatience to get enjoyments without delay, and his impulse to invest is caused by the opportunities to obtain by delay relatively more enjoyment either for himself or others."

The importance underlying the considerations of the geographical distribution of lenders versus borrowers is based on the assumption that they influence the level of access to finance and consequent saving and therefore the local economical development.

2.8 The informational problem

Informational problem is a matter that seems to have very high importance in the present debate. Henwood gives a very good insight in this matter. (Myers and Majluf 1984; Greenwald, Stiglitz, and Weiss 1984 in Henwood, 1997, p177) say " efficient market theory depends on the universal, costless dissemination of accurate information about economic and corporate prospects. But even if analyses were universally honest and while, there would still be serious communications problems between managers and stockholders, the stock market is also afflicted with informational problems".

Information asymmetry theorists generally assume that market participants are the rational self-maximises of mainstream theory; they can just never be certain of the knowledge and motives of their counterparts. As Robert Gordon said of the closely related New Keynesian School, "any attempt to build a model based on irrational behaviour or sub maximising behaviour is viewed as cheating" (Dymski 1984, in Henwood, 1997, p.177).

Henwood quotes (Bondt and Thaler 1985; Kahneman and Tversky 1979) saying "there is good evidence from experimental psychology showing that real people do not act according to the assumptions of most financial models. Specifically, people tend to overweight new information, rather than averaging it into a historical context. De Bondt and Thaler were able to u[illegible] this information to predict stock prices; a portfolio composed of a [illegible] ray of 'losers'- stocks that had been mercilessly beaten down by [illegible]arket - outperformed the averages over the subsequent three years. In other words, the initial losses were the result of overreactions that corrected themselves, but not without the passage of quite a bite of time" (In Henwood 1997, p.170-173).

Eisinger arguing around these issue states that "investors are reluctant to consider committing money to small business in part because they face high information costs as they seek to make an assessment of the risks involved in backing a firm without a record in the public market" (Eisinger 1988, p.244).

The South African micro lending industry also faces informational problems. It constitutes one issue to be addressed by lenders. One of the reasons justifying the lack of access to finance is connected with the lack of information about opportunities offered by the market to access finance. Lack of education and training also explain the situation.

2.9 General problems of high interest rates on a global scale (The international context)

The trends in the international environment are very important to contemplate in the context of the present study. "The IMF has come under increasing criticism for not adapting its conditions to the specific nature of each crisis and for exacerbating situations with inappropriate policies. Despite Michel Camdessus dismissing such criticism, saying: 'I have repented for my personal sins, but not so much for what we did in Asia'. The Group of 7 (G7) industrialised nations and the Group of 24 (G-24) developing nations, in their respective statements, called for, among other things, measures to be introduced as part of IMF or World Bank programmes. This would protect the most vulnerable elements of populations from the consequences of financial crises ... The G-24 nations, representing the interests of developing countries in negotiations on international monetary matters, called for the strengthening of social safety nets to protect vulnerable elements of the population to be included as key elements of stabilisation and adjustment programmes" (Business Day, October 18, 1998).

This trend towards protection of vulnerable elements of the population expresses a new approach of the main international institutions, to the reality of the globe. This approach forced by the financial crisis this year on a global scale indicates the emergence of new tendency to balance the international power between Keynesian and neoclassical ideologies and the seizure of the neo liberal theories to respond the need of the economic development.

The recent example of Malaysia is consistent with the above consideration:

> "Malaysia's Prime Minister firmly denounced the free market system before implementing capital controls last week. The IMF was all for this idea, although in the light of the Asian financial crisis last year it began talking about the importance of "orderly" liberalisation, emphasising that countries should not be forced to abandon capital controls until their domestic financial system were ready to cope" (Financial times, October 1998).

"Investor fear and uncertainty are what is driving our market and most of it stems from international financial problems rather than domestic issues. Uncertainty and extreme volatility will rule the World's financial markets for months to come as the world adjusts to a new order and new global financial governance. If there is a positive angle to the current financial crisis in world markets, it's that world leaders are working together to solve the problems. And the problems they are addressing are fundamental issues, such as linking social welfare needs to economic and monetary policy" (Financial Times, October 1998).

In fact, any domestic situation will be influenced negatively or positively by the international environment. For example, the emergence of the global crises in 1998 impacted negatively on the South African financial market. Apart from domestic reasons the value of the Rand went down. The inflation rate increased. Immediately when the crisis presented a positive tendency to be managed, the value of the Rand went up and the banks quickly reacted by cutting interest rates and other related measures.

The above presentation indicates new trends in the international context. There are moves in many countries, for some regulation and consequently asking for state intervention in the financial market. This emphasises the role the state has to play. The situation is no longer one where the market driving forces determine the performance of the economy. These new trends underline the critical argument of this Research Report which stresses the need for regulation (state intervention) to enforce the economic environment for small business development. One can argue that the protection of the most vulnerable elements of the population stressed by the G7, can not be successfully undertaken with higher interest rates because it results in a negative effect on access to finance.

2.10 How to avoid businesses failure

Raising and maintaining appropriate levels of finance are necessary for any business, so that adequate funding is available to support both trading operations and capital expenditure.

Businesses often fail because they have inadequate working capital with which to support their daily activities and financing requirements should be considered in conjunction with short- and medium term financial projections.

Beare comments that "in a gloomy economic climate, it is often felt that the fate of many small businesses rests on the economy as a whole. To a degree this is true, but the business owner or manager can still make a significant contribution to the future of the business and of those associated with it. The decisions and actions of the individual who controls its overall operations can make the difference between failure and survival, or in the worst case, between a straightforward winding-up and personal ruin" (Beare, 1993, p.1).

Further observation from Beare (1993, p.163) states that "a lesson learnt by many business owners and managers- not to mention personal borrowers from the credit boom of the mid 1980s has been the danger of borrowing to excess, even when there is considerable encouragement to do so. This has been illustrated by the simple but traumatic cases of many house buyers, who took on apparently affordable mortgages when the property market was rising, but who quickly found themselves in deep financial trouble when the market slowed and interest rates began to rise."

These aspects referred by Beare are very important. They are connected with the present proposal of the Usury Act to increase the exemption from R50 000. This can lead to an over commitment of borrowers with negative consequences for them.

The DTI (1998, p.3), indicates the following aspects as a major risk of business failure:

- Lack of financial control,
- Poor cash flow management,
- High gearing levels,
- Inadequate management competence,
- Poor production planning and control, and
- Insufficient marketing.

DTI points out that "due to a general lack of understanding of SMME risk, bankers tend to rely on collateral rather than on the potential profitability of the businesses. Hence, one can reach a conclusion, that there is a strong need for capacity building within borrowers. The role of Ntsika as a responsible institution in that area is important.

2.11 Conclusions

In this chapter various aspects related to the problematic of [illegible] were discussed. This entailed analyses of factors due to [illegible] shortage capital and consequent need of finance. Types of finance, for consumption and for productive purposes were addressed, arguing that loans for consumption purposes are the most common kind offered by quick loans.

It was clearly set out that the need for finance led borrowers to approach lenders to access money. Therefore as they get money they have to compensate with interest or profits. The level of this interest is the point that entertained much of the discussion.

It was stressed that the process of capital accumulation in South Africa has developed based on an exploitation process of the labour force. Consequently the society has developed unevenly. Therefore it was argued that cheaper interest rates are required to enhance access to resources to perform redistributive development in South Africa. Hence it was also argued that the interest rates ceiling is a helpful tool to deal with the South African micro lenders industry taking into consideration the market conditions determined by the discrimination and disadvantaged people as the heritage of the former regime in South Africa. It was evident from the literature the renewed awareness and consideration for the potential that small and medium business carry for development.

Observing the profile of the micro lending industry it was pointed out that the geographical concentration of lenders in the towns concurs negatively for money expansion in the community. Therefore a policy agenda has to motivate lenders to expand their activity to communities in need. This can be developed not only by formal banks but by micro lenders' institutions. So, the role of NGOs like Rural Finance Facility (RFF), Get Ahead Foundation (Geat Ahead) and others must be supported and motivated. Their experience has to be carefully assessed to avoid trends to business failure in the future.

Apart from the interest rate level's, taxation policies were considered as necessary to contribute to the access of resources in communities. The literature suggests that the general problem of high interest rates on a global scale does effect domestic economies. Nowadays the economies are so interconnected that negative or positive trends on the global economies interfere with positive or negative trends on national economies. It was also noted that there are international trends towards some regulation in the financial markets as a way of responding to a new atmosphere in a global market.

The presented views were discussed in the context of the two schools of though namely Neo-classical and Keynesian. The first arguing against polices favouring cheaper interest rates. The second supporting them. Consequently, the regulatory framework of the micro lender industry has to address the problem of interest rates within this context of thought.

It is evident from the literature that cheaper interest rates may enable access to resources and make possible redistributive development that requires access to resources. So, clearly cheaper interest rates may promote redistributive development because businesses have less to pay for the money borrowed. This view competes with earlier suggestion, to consider a certain level of inflation if it enables access to resources. This approach contrasts with that one opposing low interest rates, as alluded to by many authors mainly because of the inflationary effects it produces.

It is questionable whether low interest rates at a local level impact immediately and largely at the macro economical level. At the local level, loans are generally for working capital purposes and are small and for short terms.

From the literature review it is obvious that there is much debate around the issue of interest rate ceilings and subsidies and their effects on borrowers and communities. This is the central issue that has been coded in the context of the research hypotheses of this study. This research suggests that there is a need to look flexibly at an equitably position between capital interest and social interest.

CHAPTER 3

RESEARCH METHODOLOGY

3.1 Objective

This chapter will state the methodology adopted, data used and explain how it was processed. Any limitations or restrictions experienced which determine a deviation from the original proposal would also be discussed.

3.2 Data collection

3.2.1 Data already available

3.2.1.1 Literature review: Books, periodicals.

The literature dealing with overall issues on interest rates and small business development, macroeconomics contexts affecting it, as well as credit assessment was reviewed both considering the trends in national and international small business agendas.

3.2.1.2 Primary and secondary documentation: Reserve Bank, CSS, DTI, Khula, Journals, Reports, and Gazettes.

The impact of interest rates on borrowers is related to the overall context of small business development. Thus, much documentation from various institutions related to small business was looked at, such as; Reserve Bank publications, the Department of Trade and Industry publications, Khula, Journals, Reports, Gazettes (See References).

3.2.2 Data not yet available (Primary Research)

The research project undertook a case study method to illustrate the categories of loans that SMMEs can get access to. Field visits to the case study "site" were undertaken. This involved observations of meetings on repayment as well as sidewalk activities. Such direct observations served, as source of evidence for the case study. Open-ended interviews as well as reviewing all documentation available was also undertaken. These open-ended interviews assumed a conversational manner following a certain set of questions presented further on in Appendix B. The respondents were interviewed for about 15-20 minutes in the case of borrowers and about one hour for financial institution's representatives. These interviews were conducted at three levels. First, to financial institutions to get the general background of their positions on the issue of interest rates. Second, to borrowers to inquire of them what they experienced in terms of the interest rate being charged. Third, to local authorities get their perceptions of the small business activity in the area in which they are involved. This three level of interview process was important to get a much broader information from different stakeholders. In fact, any analyses of the impact of interest rates requires some exploration of relationship between stakeholders.

This approach, which stratifies the population into groups, was conducted because we have an interest in knowing from those groups their perceptions about the effect of interest rates charged on their business environment.

3.2.2.1 Selection

For the case-studies, two financial institutions were considered, namely

Get Ahead Foundation and Rural Finance Facility. This cases covered two study sites, Mamelodi township and Jonkilanga village. One institutional case, Alternative Finance Limited, was also considered.

These places have been chosen to get insight into the problem of two levels of environment: urban and rural.

In Mamelodi the study was undertaken based on interviews to borrowers from Get Ahead. For Kildare village, the interviews were conducted with Rural Finance Facility borrowers.

3.2.2.2 Sample size

A total of 50 people were interviewed representing: 5 financial institutions (providers), 6 related institutions, 2 associations, 2 community representatives and 35 borrowers. Appendix A provides an alphabetical listing of the interviewees.

4.2.2.3 Unit of analyses

The research was undertaken with a multiple case study design. This is because the study contains more than one site study. As prescribed by Yin (1995, p.44) each site study might be the subject of an individual case study, and the study as a whole uses a multiple case design.

A multiple case design following the replication approach was used consisting on the following steps:

- Theory development: Interest rate levels can play an important role in small business development and local economies.
- Selection of the cases: Mamelodi and Kildare and Johannesburg.
- Specific measures: Loan size, loan term, loan type or usage, interest rate level
- Data collection process
- Individual case report

"Each individual case study consists of a "whole" study, in which convergent evidence is sought regarding the facts and conclusions for the case, each case's conclusions are then considered to be the information needing replication by other individual cases. Both the individual cases and the multiple-case results can and should be the focus of a summary report." Yin (1994, p.49)

- Cross-case conclusions - Adjustment of the theory - Develop policy implications - Cross-case report

The argument supporting the idea of using case studies is referred to by Blunt (1983, p.24, in Yin, 1994, p.50) who says "just like most other data, case studies can be employed as primary data; that is, they can be used to test the robustness or validity of theories or generalisations about organisational life."

This approach assumes that the case study allows an investigation to retain the holistic and meaningful characteristics of real-life events that one intends to look at. Also, it assumes that case study as opposed to previous perceptions, is also appropriate as an explanatory tool in research methodology. In fact, as quoted by Yin (1981a, 1981) "each strategy can be used for all three purposes, exploratory, descriptive, or explanatory. There may be exploratory case studies, descriptive case studies, or explanatory case studies (Yin, 1994, p.3-4)

The same study may contain more than a single case. When this occurs, the study has to use a multiple-case design (Yin, 1994, p.44).

Multiple cases, are considered to be like multiple experiments, following replication logic. The method of generalisation from case study to theory is an analytic generalisation "in which a previously developed theory is used as a template with which to compare the empirical results of the case study. If two or more cases are shown to support the same theory, replication may be claimed (Yin, 1984, p.31). He continues saying that the evidence from multiple cases is often considered more compelling and the overall study therefore regarded as more robust (Yin, 1995, p.44).

In practical terms is not easy to follow what the theory of case studies say. The complexity of the situation in the field is sometimes difficult to represent in a case study but that, in the end, this was a useful method for the research performed.[2]

3.2.2.4 The questionnaires

The interview on the cases were undertaken using the questionnaires presented in Appendix B. The unstructured questions served to remind the interviewer about the information needed to be collected. Three types of questionnaires were considered. Questionnaire 1 was used to interview borrowers and Questionnaire 2 to interview financial institution's

[2] **The major limitation of the study is the unavailability of records of income and expenses to be analysed because of the fact that borrowers are recently established and usually don't have formal accounts. Therefore, assessments of the effects of a single variable like interest rate on the individual are difficulty.**

The diversity of purposes of loans and providers is also another limitation, particularly when one seeks to bring about conclusions to contribute for any legislation.

The fact that the present study is based on a few case studies is also a limitation for broader generalisations. A much wider study would need to be undertaken.

representatives and Questionnaire 3 to interview local authority representatives.

CHAPTER 4

DATA ANALYSIS

4.1 Objective

This chapter will detail and analyse the research data that has been extracted from the study. In this exercise it will be followed the 'second type' of written reports which Yin indicates that this type of multiple case report will contain multiple narratives about each of the cases singly (Yin, 1994, p.135).

The data extracted presents the two study sites mentioned in the previous chapter, namely Mamelodi and Kildare/Jonkilanga, and analysis of the hypotheses to be tested.

It is difficult to compare the results of the cases because they are heterogeneous. However what is presented here is the evidence found in the field and it was rich enough to draw conclusions.

The perception of data analysis in this study is influenced Yin's analysis:

> "Generalising from case study to theory does not only facilitate the data collection phase of the ensuing case study. The appropriately developed theory also is the level at which the generalisation of the case study results will occur. This role of theory has been characterised throughout this book as "analytic generalisation" and has been contrasted with another way of generalising results, known as "statistical generalisation.... The use of theory, in doing case studies, not only is an immense aid in defining the appropriate research design and data collection but also becomes the main vehicle for generalising the results of the case study" (1995, p.30-32).

4.2 Geographical cases

4.2.1 The case of Mamelodi

4.2.1.1 Background

Mamelodi Township located near to Pretoria has 154846 inhabitants (Central Statistic Service, 1991). Because of the geographical position, near to Pretoria, Mamelodi was, considered by the population, as one of the most oppressed townships in the country in the apartheid era. Nearby was located the most feared police station in the country. In spite of this, it was a place where many political leaders emerged and played important role in the struggle to release the country from the apartheid regime.

Like other townships, the community in Mamelodi consists of poor people. According to the Population Census 1991, 63% of the population are registered without any source of formal income. Of the remaining 37%, more than 60% have, per year, an income of less than R850.

People of Mamelodi struggle to find jobs. The majority of the population is of an active age (see Figure 5). Many are unemployed because they never got jobs and others because they were retrenched from previous employment.

As a result the level of crime is high and has become part of life particularly in last few years. The South African National Civic Organisation-SANCO has tried to contribute to the reduction of crime. Those contributions did not last long because of disagreements with local police authorities responsible for security in the area.

On the education side the situation is also problematic. 23,12% have no education and 55,58% of the remaining 76,88% have less than Standard

6 (See Figure 3 and 4). The pupil ratio in schools is almost 1:40 and in some schools the figure is higher. This scenario questions the level of education offered and consequently the future capability of the area to engage in progressive development (Central Statistic Service, 1991).

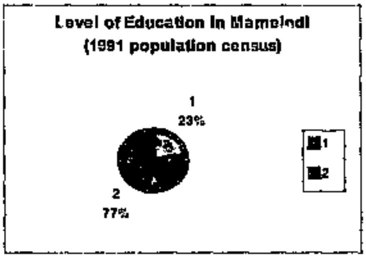


Figure 3

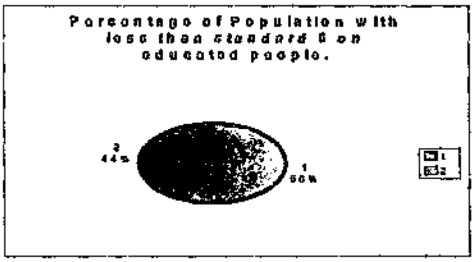


Figure 4

On age levels we found that, 7,9% (12206) are 55 years; 52,67% (81345) are between 20-54 years and 39,43% (60895) are less than 20 years. (See Figure 5). This information is important to understand the kind of people living in the area and how this relates to the capacity of small business activity in the area (Central Statistic Service, 1991) (CSS).

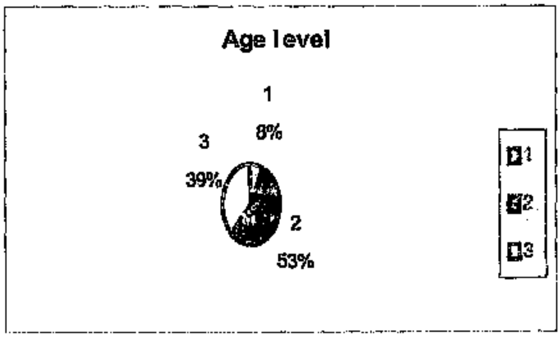


Figure 5

The majority of people in Mamelodi speak Northern Sotho as their home language. 27.95% of the population belong to Black independent churches whereas 40% are unspecified and belong to no religious group

(Central Statistic Service). This information helps to understand the composition of the population in the area.

Mamelodi is divided in two areas. In one area, the city council built houses and on the other area the population build their own houses. Health and sanitation are also a matter of concern because the level of services offered are not good particularly in the latter area where people face problems of housing, water, and electricity among others.

This scenario shows the result of state failure to provide a viable solution of needs of low-income people. This failure was determinate by the traditional lack of commitment, involvement and interest of the past regime.

The dilemma of housing, water and electricity constituted the biggest challenge to be addressed in Mamelodi. In particular electricity constitutes a main issue that led SANCO and the City Council to fight permanently because of systematic cuts in electricity supply to many households in the community. In general people are of lower income and others unemployed and even then they are not able to pay the electricity they consume. People in Mamelodi claim that the electricity tariff is too high. It increases every year. They connect this with the situation of increased salaries of the City Council employees. "The major part of the budget is spent on salaries and it increases every year" (SANCO, 1998, August 24). SANCO suggested specific and independent research to be done to deal with the issue, as a way of finding appropriate and balanced measures. They argue that, "there is a need to know who are able to pay and who are not and after that we can reach a compromise to go further with an appropriate solution" (SANCO, 1998, August 24). They are implicitly suggesting a cross-subsidised solution. The situation now is that the electricity department is running all over Mamelodi cutting the electricity supply. People comment that soon nobody will have electricity in their houses. Moreover the level of illegal reconnection is growing significantly.

Electricity plays a meaningful role in the social and economic life. So, cuts in electricity frustrate social and economic relations in the community. The LEDEC paper approaches this issue saying that electrification reduces reproductive rates through altering social relations and generating economic opportunities, and as a result, women in electrified areas place more emphasis on children's education than on children as productive agents. Also it has been estimated that one new small business can be created for every ten electricity connections (LEDEC, 1998, p.27).

Get Ahead Foundation is a financial NGO formed in 1987 by Desmond Tutu as an effort to help unemployed, poor, and most disadvantaged people to fulfil their needs when the new government took power. It was initially targeted to woman. The headquarters are in Pretoria City (Stembele, 1998, July 24).

As a result of its growth Get Ahead now have branches almost throughout the entire country. Silverton is now where the branch office of the Pretoria region is located after they moved from Mamelodi because of logistic problems. This branch covers people from Mamelodi, Mabopani, Sochangovo and Garankovo (as sub-branches).

4.2.1.2 The case

We are going to focus our study on the Mamelodi sub-branch that encompasses almost 1287 clients divided in 286 groups under control of three loans' officers. A total of 22 borrowers were interviewed based on three different areas of Mamelodi.

A philosophy of Get Ahead, is for people to get access to loans they must be in a group of five. They have to organise themselves and come to see Get Ahead. Also, they have to be ones that already have started some kind of business to be eligible to get loans. They can also accept one or two members of the group without any businesses if other members of the group support them. The group is responsible for each member making his or her loan payments on time. There is usually some form of pre-business training and group buildings before loans are made to potential borrowers. Get Ahead finds it a way of providing borrower supports among them. There is a sense of group solidarity. When one member fails to repay in one month, he can be supported by others members of the group. This worked successful in Bangladesh. This is an adaptation of the Graameer Bank lending methodology. These programmes are now in place in many parts of South Africa.

The basic idea of group lending is to lend funds to a group of borrowers who plan to go into very small labour-intensive businesses in the same community. Micro-enterprises are usually operated from the home or the street. Micro-enterprise programs usually make very small loans to a group of 3 to 5 borrowers, each borrowing under R1 400. They include such businesses as home-made jewellery or garments, handmade shoes, or speciality foods for school, unprocessed food stuffs (grains, fruits and vegetables), selling of new and second - hand clothes, small retail shops and limited small - scale manufacturing.

4.2.1.2.1 Hypothesis 1

The result of the interviews indicates that 95% of the interviewees are female. About 95% of the interviewees said that they did change their life because of access to loans; 95% agree with group schemes; 25% knew about the lending scheme through other clients and 75% from neighbours; Almost 75% said that they don't have problems in repaying and 25% said that they don't have any alternatives. A great majority of 90% said they increased the stock and 20% started their business before joining Get Ahead; 10% of the borrowers are more than 50 years old and 20% are between 40-50 years and 70% between 30-40%.

As indicated in point 3.2.1 the Hypothesis 1 states that, "For small, short term, working capital loans the impact of interest rates is lower."

From all the interviews with borrowers of Get Ahead Foundation in Mamelodi, it was found that 90% of the clients said that the level of interest rates charged was not so high and that they were able to repay their loans according the requirements prescribed. Borrowers find that the interest rate charged is not something they question and they stress that is not possible to get money without any costs. For example Beatriz Sibue (1998, September 7) says, "interest rates are not a problem because we knew in advance about that." Emilia whose business is selling curtains states that "there is no problem with the interest rates. It's fair because they have to improve their money" (Emilia, 1998, September 7). The example of Lydia presented later, is an illustration of one individual's impact on the credit.

Borrowers find the interest rate charged by Get Ahead as reasonable when they compare with the rate charged by quick loans organisations, known as '*mashonisas*'. All of them said that they could not afford to pay back loans from *mashonisas*. That's the reason they do not approach them although the *mashonisas* are much quicker to give out loans. Clients do not feel comfortable with the collateral they ask. For clients the main point is to get access to money as they see that they will have a better chance if they have access to money. According the branch manager of Mamelodi the repayment rate is about 90% on average every month. In some months it goes up to 97%. December and January are in general bad months (Maweto, 1998, September 9).

The interest rates charged by Get Ahead is 15% for 4 months; 21% for 6 months and 23% for 9 months; 32% for more than 12 months. They give loans on a weekly basis and the repayment is also on a weekly basis. Almost all the loans are for commercial purposes and the loans generate cash flows almost immediately. However, is appropriate to mention that almost every client does not apply the whole amount of the money they get for the purpose they ask for. They use it for school fees, food and other things. The branch records show that in general most illiterate people are those who present a better level of repayment. Most of the clients are women.

Many of the borrowers find the amount they get reasonable. But some complain, suggesting increases of up to R3 000 to R4 000. Actually, their suggestions are still under the scope of the amount laid down the Usury Act (R6 000).

Although some people complain most interviewed find that the group solidarity is a useful way to exchange experiences and to help one another, particularly in the case of crisis. Emilia, for example, said "to be in a group is good because it is possible to share experiences and difficulties. To be in a group gives motivation on business." Regina, on the other hand, said "sometimes it is good to be in a group but sometimes it is not because people do not co-operate. ... The idea is good but I think that people who don't repay their loans have to be retrenched from the group." (Emilia, 1998, September 7)

Of note in the above presentation is the strong evidence that for small, short term, working capital loans the impact of the interest rate is not significant. This serves to confirm the hypothesis formulated.

Example 2: Lydia in Mamelodi - Get Ahead Foundation

Lydia is 31 years old. She is a mother of three children. Her business is selling cold drinks, cigarettes, oil, school lunches, clothes and duvets in her small shop. She works together with her spouse and her younger brother. She found out about the credit scheme through her neighbour who invited her because the neighbour remained alone in the group of four because the others misused the money received and they were not able to repay. The money she receives from the credit is helpful. She indicated: 'I do not see any problem with the interest rate charged'. The reason she borrowed money was to expand her business. She started the business with the money she received from her spouse. Now her spouse is unemployed. He was retrenched from his former employer. That is why now he works together with Lydia.

From the first loan of R700, which she got in 1997, she has increased the stock of cold drinks she sells. After she repaid this amount in four months in February of 1998, she got another loan of R1 200. Besides cold drinks she has started to sell a variety of drinks like brandy, beer and others. She has also managed to repay this loan in four months. In September 1998, Lydia got the third loan of R1 400. With the money she said, "I intend to buy a freezer, a big one, to help my business. I am interested in buying a freezer instead of continuing buy ice every morning to freeze my products." Lydia is expanding her business. She has no idea if she will continue to borrow. But she has a sense that soon she will be able to finance the business without new loans (Lydia, September, 1998, 18).

4.2.1.2.2 Hypothesis 2

Hypothesis 2, as indicated in Section 1.1.4.2, is that the circulation of resources in a community is higher in case of lower level of interest rates.

The research results indicate that because the interest rates charged are low, people are willing to ask for loans and then to do business that enables them to fulfil their needs.

Because of the low level of the interest rates charged borrowers can improve their previous businesses. Some of them, in trying to improve their businesses, need to employ another person to help in their business. Multiplier effects can attentively be figured out. All three loan's officers interviewed see something changing in the communities where they are involved, although they said that is not too visible now. "Those who got loans have made a difference in their lives" (Nkosi, 1998, September 10). SANCO people at Mamelodi shared this sentiment. But they observe that, "in Mamelodi there is a problem of how people can start a business. Many people do not know that Get Ahead exists. That is why some go to quick loans. The financial institutions must work with SANCO instead of only the City Council." They also claim for more transparency on the criteria of selection of clients and more openness in the institution. Likewise they find that the numbers of borrowers are not large enough to make any visible change. The loan processes had not have enough time to mature and be reproductive.

Considering Hypotheses 2, it is difficult to prove that low levels of interest rates favour higher circulation of resources in a community. It is necessary for more detailed research to be done in order to evaluate the situation. However, there are good indications that prove the hypotheses.

4.2.2 The case of Kildare

4.2.2.1 Background

Jonkilanga with the population size of about 50 000 people is a rural area in Mhala District in the Northern Province. Jonkilanga is the name of the former tribal chief of the area encompassing 13 villages. It is located about 100 km North of Nelspruit. It is near Pietersburg, the capital of Northern Province, where the district administratively belongs. That is the reason why people of Jonkilanga and other neighbour areas like Bushbuckridge, Tulamahacha are more connected on a daily basis with Hazyview and Nelspruit in Mpumalanga Province. People from Jonkilanga stock their products and go to shop in Mpumalanga not in the Northern Province because is too far. They have been claiming to be part of Mpumalanga for long time. They do not see any advantage to being part of the Northern Province. On the contrary, they see that as the major problem of their lives.

Kildare is one of the thirteen villages of Jonkilanga with almost 10 000 inhabitants. Like other rural areas one of the main problems is water. People have to struggle to get daily water. Kildare also faces problems of sanitation and health. Although the situation has been changing positively, because building construction has been taking place, housing still an issue. Recently the village was connected to an electricity system. The electricity access is through cards. An Eskom post manages the process of electricity supply in the village. People, through card system, can buy the amount of electricity they can afford to pay. When they cannot pay they stay without electricity. This is what happens in many households headed by women because their spouses have passed away, or are working away in towns, or they have married another woman elsewhere.

The majority of people in Kildare speak Shangani/Tsonga. The quantity of 17.475 of the population belongs to Black Independent Churches whereas 75% are in the group of unspecified and no religion group. The portion of 52,28% (123.147) has no education and 72,90% of the remaining 48,72% have less than Standard 6.

Kildare has nine schools. Two are Pre-schools (Malamele and Tipfuxani); four are high primary schools (Jan Rikhotso, Njojela, N'wankupana and Jonkilanga), and three are secondary schools (Bondzeni, Bunny Khosa and Ngalani). The distribution of teachers among the Kildare Schools is irrational. That's why is possible to see a variation of pupil ratio from 1:30 to 1:62. This situation reduces the quality of education offered.

Some parents struggle to get uniforms for their children to go to school. Their level of income is too low to afford it. 87,9% of the population are registered as having no formal income. Of the remaining, 12,2% more than 63,77% have equal or less than R250 as an annual income. Also, 90,4% of population are registered as not economically active. Of the remaining 9.6%; 5,69% are in agriculture, hunting, forestry and fishing; 7,65% in the wholesale retail trade, catering and accommodation services, 24% in community, social and personal services and 46,38% in activities not adequately defined (Central Statistic Service, 1991).[3]

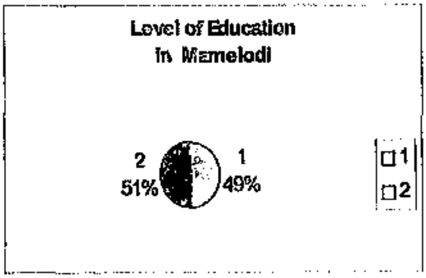


Figure 6

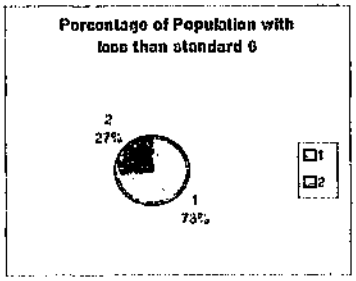


Figure 7

[3] Note: Because of unavailability of specific data for Kildare it was used, as reference, data from Mbala district where Kildare is located.

4.2.2.2 The case

Rural Finance Facility (RFF) is a financial institution operating in the Mhala area. Like many NGO's RFF is one institution extending all over the country. RFF has its headquarters in Johannesburg. They have two operation areas: housing and micro lending. In housing they give loans through employers. The repayment is by monthly deduction from salaries. They started earlier in 1998 to give housing loans in the Nelspruit area. In three months, the number of borrowers numbered about two hundred. This shows how high the demand is for this kind of credit.

Mhala sub-branch is part of the Nelspruit branch. It is located in Jonkilanga, more specifically in Kildare village. It has four centres, (Hlanganani (35), Nkonjana (20), Bankuna (20) and Tsama-Hosini (20)) with a total of 95 clients. In general, borrowers in this sub-branch sell clothes, cold drinks, fruits and frozen chickens among other things.

As part of the study only Hlanganani and Tsama-Hosini centres were visited. A total of 13 borrowers were interviewed from the two centres. This constituted 24% of the population of borrowers.

Like Get Ahead borrowers, RFF borrowers receive loans on a group basis. The difference between the two cases is that they concentrate on four groups and this constitutes a centre for repayment. This is an effort to reduce the costs of supervision. The evaluation of the level of repayment is not only by group but also by centres. This is a matter of much complaint at the Hlanganani centre. For example, the five groups at the Hlanganani centre were unable to get new finance because two groups had delayed in their repayments. One can argue that RFF is too rigid in this aspect, because all groups are forced to repay at the same time. It is questionable whether this rigid approach is effective.

In general, every month one or two groups are unable to pay their instalment. One reason is that the business cycle does not always coincide with the payment cycle. Another reason is the misuse of the loan. But this is rarely the case. According to the loan officer the saving awareness varies between geographical zones and across individuals. In Hlanganani the saving awareness is low.

The Branch manager of Nelspruit branch stresses that the rate of repayment relies too much on the role of the loan officer in the area of activity. He means where the loan officer is active, the repayment rate is high, but where the loan officer is passive the repayment rate is low. Added to this is the perception as Kiiru & Pederson (1997, p. 28) comment with regard to the example of Kenya Woman Finance Trust, "because of the constant interaction between clients and the credit officers, other client needs, such as basic training in business management and record - keeping, have been identified."

4.2.2.2.1 Hypothesis 1

The result of the interviews shows that:

About 85% of the interviewees are women; only 23% of the loans are for productive purposes (traditional beer, create chicken, sewing etc); 77% of the interviewees are selling different types of clothes, cold drinks, chicken pieces, meat, fruit and vegetables.

A clear majority of 99% of the interviewees said that the loans did change their lives. Merely 15% of them do not support a group-organised centre as a base for repayment; only 23% are indifferent and 62% agree about group work. A portion of 30,76% knew casually about the lending process whereas 15% knew from other clients and 54,24% in meetings organised to explain about credit process. Only 15% said that the interest rates are high and difficult to support but 70% said that they don't have a problem in repaying and 15% said that they don't have any alternative way to access money; 20% of those interviewed borrowed money to increase their business. Simply 30,76% of the clients are more than 50 years old, 47% are between 40-50 years and 23% are between 30-40 years. Just 15% of the interviewees started the business before joining the lending process from RFF.

In general the interviewees found the interest rates charged are reasonable. They always compare it with the interest rates charged by quick loans. They feel that the level of interest rates charged is not the main constraint for repayment. For example Safeline Nhovo said, "interest rates are a problem because it is a cost, but it is fair to pay it. Although it is heavy, with some effort it is possible to repay it." She continued to say "working in a group is helpful if people understand each other." Although they use part of the money, for other purposes not the ones they applied for, they are able to pay back the money to the lender. This is because the interest rates charged are low and because short loans generate fast cash flows.

It was found in the field that almost every client does not use the total amount of money for the purpose they ask for. They use part of the money to pay school fees and buy uniforms, to buy food and other things. This is one reason why some clients delay in paying their instalments.

This hypothesis was confirmed by the results of the research that found a high repayment rate.

4.2.2.2.2 Hypothesis 2

In light of Hypothesis 2, which relates to the circulation of resources in the community it was found that:
People see something changing in the community. People are able to have more and diversified stock for their businesses. Lucy said, "I am now able to give food to my children and I can sustain them in general. The interest rate is not a problem."

They say that they are in a better social condition now than before. They are now able to fulfil some of their needs; they could not do so before. The example below of Clara is an illustration.

However these new businesses are claimed to be dishonest by some of the local established businesses. These are the owners of shops, bakeries and others. They accuse the new business of not paying tax. In Kildare there are almost 13 different kind of shops.

Example 3: Clara Nhamby - Kildare

> Flora Nhamby is an old woman in Kildere-Jokilanga with eight children. She is a widow. She sells traditional beer and cooked chickens. Three of the children are married and stay in the same village. One of them Clara is also a widow. She returned to her home (her mother's place) after her husband died. After some time at home, she was forced to do business, to sustain her four children. The pension she received from the company where her spouse worked was too little. She started tailoring, and she asked for loan money to sell chickens and clothes around the neighbouring village. She used to buy clothes in Nelspruit and sell them around the village. The profit was so little that it was not helpful enough to fulfil her basic household needs. In 1997, she first learned about RFF in a meeting held in the village to introduce their activities. After that she received a loan that enabled

> her to improve her businesses. She increased the stock of products and instead of going every week for stock she reduced it to two times a month. Her business is going well. She said, "the credit is helpful for our lives. Without credit I would be in very difficult situation to survive. Now I opened my account where I deposit my savings. The problem is that the bank is located little bit far from here. I am building my house. I did almost 40% of it. I plan to finish next year if my business continues doing well" (Nhamby, 1998, October 6).

Analyses of the effect of low level of interest rates charged by the RFF, in the community, reflects a possible scenario where people become more empowered to sustain their lives. It is difficult to prove this hypothesis because of a lack of quantitative data available. However in analytical terms it can be realised that the trends indicate for the possibility of proving the hypotheses.

4.3 Institutional case

4.3.1 The case of Altfin

This case was included to enrich the research because Altfin offer a greater range of loans for education purposes, personal loans, home loans and death benefits. Also the criteria for repayment is based on salaries. This is different from the Get Ahead and RFF, which is more, confined to personal loans and the repayment is based on the results of business activity.

Altfin is another financial institution for housing finance. In practical terms their loans are for extension and some level of renovation of houses. The amount of money borrowers can get according their income is not enough for them to build new houses. The finance process is through employers.

Many of the borrowers are teachers, and civil servants. There are also borrowers from some companies around Johannesburg.

The Johannesburg branch is located in Braamfontein. It is part of the western region according the Altfin structure. From interviews with clients from the Johannesburg branch it was found that 90% of the borrowers do not use the whole money for the purpose they ask for. They use it for food and in some cases to buy clothes and other expenses. About 57,14% of the interviewees are female and 86% knew the credit scheme from colleagues at work and 14,28% by pamphlet. 14% think that the interest rates are high and difficult to repay, 57,15% are female, 15% don't find it as a problem and 28,57% said that they don't have any alternative. Merely 28,57% borrowed money for housing (improvement and expansion), furniture and TV, 28,57% for school fees, and 42,86% only for housing. Simply 28,57% are more than 50 years old, 14,28% are between 40-50 and 57,15% are between 30-40 years.

All of them are concern with interest rate charges but they do not find it a problem. They always compare the interest rates they are charged against those charged by the cash loans (*mashonisas*). Because they get their loans through their employers the repayment rate is almost a hundred per cent. This is appropriate because this kind of loan does not generate cash flows per se. The salary is the source for reimbursement. Some of the clients interviewed were applying for loans for the second time.

4.4 Policy positions on regulating the level of the interest rates

Specific interviews were carried out with individuals from different institutions. Basically the results of the interviews led one to distinguish two different positions in relation to the regulation of the level of the interest rate. On the one side we find those defending deregulation and on the other those against deregulation.

Before we go into details about the twc positions let's consider some theoretical aspects about what regulation means. Many definitions can be applied but let's simply understand that regulation concerns the set of rules which determine key aspects of the operation of banks and other financial institutions, and the way in which these rules are administered.

Regulation has several goals. According to MERG (1993, p.259) "the more traditional goals involve regulating the interest rates banks pay and charge, or regulating other terms of lending. However in the past decade, regulation of banks and other financial institutions have changed throughout the world. The Reserve Bank of course, plays key role in this process. One of the major debates on the role of the Reserve Bank is concerned with the obligation to maintain confidence in the monetary system and be responsible for it. MERG (1993, 258) suggests that the Reserve Bank "should organise a system of deposit insurance, financed by the banks, to increase people's confidence in the security of their savings". The assumption is to increase the use of bank accounts. They also suggest the use of regulation to monitor the allocation of bank credit to different sectors and to impose sectoral target for credit allocation. They continue emphasising the promotion of good practice by banks as well prohibiting discrimination on the grounds of status related to race or gender and also to let banks use simple language and vernacular languages in documents and thereby increase transparency. This seems to be good for South Africa where the bank structure and system was organised to serve the minority of the population.

4.4.1 For deregulated interest rates

The interviews from the study defending deregulation argue for a market driving force to regulate the level of interest rates. Therefore the state has to reduce their level of intervention on the economy. The interviewees advocate a need for a cost recovery process for business services as well as competition as instrument to determine access to capital. The perception underlying the view of the interviewees assumes a context of a perfect market where everyone has the same opportunity.

For Brown, "financial deregulation, initiatives generally seek to eliminate price controls, portfolio requirements, product restrictions, and barriers to entry that operate within domestic financial service markets." He continues by saying "the policy argument most commonly advanced to support financial deregulation is that it will provide direct benefits to consumers in the form of product innovation, increased competition, and lower prices" (Brown, 1996, p.1).

Brown emphasises three aspects on financial regulation. The first is about "the financial deregulation unaccompanied by stronger prudential supervision and regulation to curb excessive risk-taking by financial institutions can lead to a rising incidence of bank failure and a host of direct and indirect injuries to consumers" (Brown, 1996, p.1).

The second relates to the "financial deregulation unaccompanied by rigorous competition (antitrust) policy and new mechanisms to more effectively serve consumer information needs is not likely to enhance price competition in retail financial service markets on any sustainable basis." He continues pointing that "a strong antitrust policy against concentration is needed to ensure that retail financial service markets remain competitive on the supply side. On the demand side, new and more effective consumer information mechanisms are needed to enable consumers to participate effectively in increasingly complex financial service markets. Without both components in place, financial deregulation is not likely to stimulate real price competition" (Brown, 1996, p.2).

The third is that the "financial deregulation unaccompanied by access safeguards can diminished access to banking services for lower income persons, low and moderate income neighbourhoods, and small business. Financial deregulation and technological change produce certain structural and operational changes in the banking industry – i.e., stronger competitive pressure, industry consolidation, standardisation of loan products, centralisation of loan approval authority, and pressure to maximise fees and service charges." He goes further indicating that "the evidence suggests that these charges tend to reduce both the willingness and the capacity of banking institutions to serve economically disadvantaged or isolated communities, small-sized businesses, and various non-standardised credit needs." (Brown, 1996 , p.2)

The Alliance of Micro Enterprise suggests "industry self-regulation instead of government intervention". According to them "the market situation in South Africa has changed and therefore the Department of Trade and Industry must change the regulatory environment leading to self regulation of the industry and playing a role of co-ordination between different stakeholders (players)" (AMEDP, 1998, August, 23). One can contrast this view because South Africa is basically a society with a strong level of discrimination as a heritage of apartheid. So the state has a role to increasingly balance that situation which a self-regulation approach can not consider.

Supporting the same arguments, Rubin Jafta from Khula argues that the level of interest rates is not the issue for borrowers. He stresses access to money as the point to be worried about. He justifies this indicating that "although borrowers have been charge 50% to 200% of interest rates from the lenders (*mashon'sas*) they continue to go back to the lenders there to ask for more loans" (Jafta, 1998, July, 24).

Naughton concurs to the same view arguing that "the main aspect is the access to money and the level of interest rate is secondary." She also considered that the cost of money is the important aspect that led to the creation of the problem of the lack of business access to money and then competition is the only way to decrease the interest rate. So the Reserve Bank policy is relevant to the cost of money" (Naughton, 1998, July 28).

4.4.2 Against deregulated interest rates

Interviewees against deregulation of the interest rates argue for state intervention in the economy to play key role in the process of regulating the interest rate level in order to balance the uneven development around the country. The basic argument presented is that the South Africa market is not mature enough and that most of the people are not educated enough to play in a full market economy.

For example J White and Puso Matlou (1998, August 10) said, "there is a need for limitation of interest rates charged because the market is not educated". They continue "we have to pay attention to possible over-commitment of borrowers because of the increasing level for exemption. This is going to kill the market because the clients will not be able to pay back and then [illegible] able to continue their businesses. Because of that, appropriate legis[illegible] necessary to help the disadvantaged people who lack resources and punish the loans chart lenders".

For instance, Collete Cain (1998, August 28) supports regulation but she observes that it must be on policy basis, and with clear targets. Going further, she also observes that, as a result of the proposal amendment of the Usury Act to increase exemption to R50 000 for the interest rates ceiling "cash loans and banks will be the beneficiaries" and not the more disadvantageous people.

Rashid Ahmed (1998, August 17) from Delloite and Touche presented a similar observation. He said, "exemption is going to accommodate a big interest group like the banks and not help the very poor who are almost unbankable because of their low level of income." He continues his argument indicating that "there is no lack of money in the country. The main problem is the requirement to access the money." The first part of this argument is similar to the argument presented by (DTI, CSBP, 1998, p.2) and mentioned earlier in this report.

Comment from Joe Shabangu (1998, September 23) refers that "If we lend large amounts of money for each borrower it will constitute a way to give many problems to borrowers as well to financial institutions". He disagrees with the view that the market is open for everyone. He suggests that there must be some regulation to help disadvantaged people." He mentions the situation of the market as one where "rich people become more rich and poor people more poor."

Dr Porteous' advice in respect to this is about the need to distinguish regulation according the sector of activity instead of generalising. He says, "for housing there is no need for such levels of credit exemption" (Porteous D., 1998, September, 28). This is because housing credit is undertaken on a salary basis and thus not enabling the target group to borrow high amounts.

Lance Clever, from the housing sector, argues for the first stage increase of the exemption base to R10 000 for 1,5-2 years and later after three years to R50 000 taking into consideration the affordability and the education of the population. He justifies this saying that "we have to deal with the real market where there are people who have access and those who do not have access. Those who have access have experience and do not need protection and those without it need access and protection by regulatic Clever L., 1998, October 8).

The adoption of self-regulation was criticised as not being appropriated for the South Africa context. Dr Porteous suggests a strong consumer organisation to balance the forces between creditor's suppliers and creditors' consumers. Collect Cain from Provincial Department of Consumer Affairs by saying "is necessary for consumer protection and not only paying attention to the supply side of the market" (Collete, 1998, August, 28) she was implicitly also arguing against self-regulation.

Supporting the need for regulation Dr. Porteous' warns against over-regulation which can obstruct good processes of service delivery.

John Francis from Ntsika argues for the need for sate intervention like in Japan where the experience of community banks supported small business and created a new market and consequently contributed to the development of the country, (Francis J., 1998, July, 12).

The rationale for deregulation is based on the assumption of the superiority of the free market compared to government intervention. However evidence seems to show that the "application of the free market principles to the financial service sector is unrealistic because it overlooks the irreducible responsibility of govern ents to maintain stability within financial markets and protect consumer funds entrusted to financial institutions" (Brown, 1996, p.5). Brown mentions the problem of risk that arises by increasing the competition within the financial service by saying "financial deregulation that is successful in increasing competition is likely to create a need for stronger prudential regulation."

The access to basic financial services is critical in our discussion. We have pointed to the need for money access for the most disadvantaged people. One of the main problems of the financial deregulation is to exacerbate the problem of access to basic financial services by disadvantaged sectors. (Brown, 1996, p.11) argues that "banking institutions operating in deregulated financial markets tend to be less inclined to serve low and moderate income depositors, since they present fewer profit opportunities, and more inclined to raise fees and service charges on deposit and payment services for consumers." The example of USA shows a relevant approach toward access mechanism to financial services in a deregulated banking market. This is through the U.S Community Reinvestment Act (1977) that "subjects banking institutions to an affirmative obligation to serve the credit needs of the disadvantaged sectors within their communities, especially low and moderate income and minority neighborhoods" (Brown, 1996, p.26).

As it was said in Chapter 2, in the literature review, the interviews confirm that the interest rates issue is a very controversial matter. It encompasses many aspects to be considered. So a balanced approach, although difficult, is required to deal with the issue.

Although we have tried to distinguish the problem of regulation in two groups: one against and the other favouring deregulation, it can be understood from the interviews that it is difficult to present a clear barrier between the two. There is mix of positions between them.

Brown (1996, p.2) for instance, acknowledges that "the complex web of subtle impacts and interactions makes it difficult to draw balanced conclusions about financial deregulation." Moreover, he underlines, "given this complexity, it is relatively easy for ideologues or powerful vested interests within the financial service industry to present superficially reasonable assessments of financial deregulation that, in fact, overlook or gloss over its impact on important consumer and local community interests." For Brown (199?, p.2) according the general economic environment pending to deregulation, the point to be discussed is what type of safeguards should be developed to contain the negative impact of financial deregulation.

However the interview results in this study show that there are more tendencies for some regulation.[4] This implicitly indicates that many players are getting a sense of need of state intervention in the process. This underlines the basic argument of our study, that the state has a role to play in intervening in such a way as to balance and favour the more disadvantaged people.

[4] The interviews have been included as appendices because we felt that they help in the understanding of the results of this Research Report.

CHAPTER 5

INTERPRETATION OF THE RESULTS

5.1 Objective

This chapter will focus on the meaning of the results found in terms of the hypotheses formulated and presented in Chapter 3, and the underlying ideas also presented in the Research Report thus far.

We will interpret and analyse the data obtained from the interviews in the context of the general framework established for the present study. After presenting the multiple narratives in Chapter 5, in the context of a multiple case study methodology this stage is to present the cross case analyses as Yin suggests (1994, p.135).

5.2 Hypotheses to be tested

5.2.1 Hypotheses 1

"For small, short term, working capital loans, the impact of interest rates on borrowers is lower."

The research results indicate that the interest rates constitute one issue to be targeted in the present context of policy debates around the interest rates. Although there are some slight differences in the results in all cases the result is the same. We have replication.

Analysis of the results has to take into consideration that the micro lending market encompasses many stakeholders' interests Broadly we have the government that is questionable to some stakeholders in a context of market economy, financial institutions, banks, micro lender's associations, an alliance of micro enterprise and the borrowers in general. The last do not have any representations.

Although many of the interviews, from the lenders and borrowers' side indicate that the interest rate is not the main issue to be considered the situation is far more complex. The perception that comes out of the interviews shows a matter of priority among borrowers. This perception assumes that the micro lenders are the only players in the market. This is not true. They minimise the high intervention of quick loans charging on the market, particularly those operating illegally. Although in one sense, one can agree that they play a significant role in the market, it is not enough to change their lives. The quick loans are also taking advantage of the low levels of capital available in the economy to exploit the weak condition of borrowers. In fact, the perception underlying the response obtained from the interviewees expresses a matter of priority between access to capital and interest rates charged. Another aspect influencing the borrowers is a matter of lack of information and immediate need they have for money. In pragmatic terms, it is reasonable to understand that borrowers cannot be worried about interest rates without money being accessed.

It is important to remember that access to capital is a problem. The banks' criteria are so strict. The banks usually reject SMME loan applications on grounds of poor credit checks, weak business plans, or insufficient collateral.

Any access to money is important to a desperate borrower. The borrower becomes excited at the chance of getting access money. There is a psychological behaviour at play. The awareness is "better this than nothing".

One significant point to be considered is that the amount being given per loan is small in capital terms and is for a short term. This situation, which underlines the critical aspect of the hypotheses in the study shows that the impact of interest rates is not significant because the use of capital generates quick cash flows which enable borrowers to repay back their loans.

From the words of borrowers interviewed the level of interest rates charged by quick loans is too high and their condition unacceptable. They acknowledged that, "if people are going there it is as a last alternative and not because they do not care." They do not have the possibility to find alternatives to get money in the household and community environment where, in general, the level of income is low. Some are desperate enough to go convinced that "first one gets a loan and later think about the interest rate issues" (Maweto R., 1998, August, 23). They assume that the problem of interest rates will be sorted out in one way or another once the money is available. The point for them is "let's have the money to solve the immediate need and then we will plan to repay the loan." Sometimes this goes well but sometimes not. In latter cases the borrowers suffer from penalties charged afterwards. The ultimate result is worse than if they had not borrowed.

Although many people are able to repay, and according Professor Du Plessis, (1997, p24) they feel happy to be helped in their social and economic life, it is important to look at the issue in a development perspective. They were helped to solve an immediate problem and after that being charged high interest rates and the strong collateral being asked punishes them. This compensation is too hard. It is also important to look to the capacity of the reproduction of the capital lent. The way quick loans operate does not contribute to self-sufficiency or sustainability in the long term. What happens is the borrowers are enrolled in a cycle process of solv' ıg immediate needs without any prospective for change. Even if some of the borrowers can succeed in their ı ɔtions with cash loans there is no enough evidence to generalise this in a development perspective.

The research results also indicate a problem of information around the small business environment. Many borrowers do not know where the alternatives to quick loans are. On the other hand, the micro lender's institutions are not enough for credit demand. People take a venture of approaching quick loans because of their immediate needs. This is a question of time. In some sense and in immediat. ɩective the price of loans from normal financial institutions becc apparently higher because of the long time they take. Therefore borrowers substitute with quick loans that seem to be charging lower interest rates because the process is faster. This expresses the concept of cross elasticity of demand.

It is a general concern that the interest rate ceiling is necessary in a micro lending industry. The underlying assumption is that the real situation of the country is not one of the open market. The market distortion, heritage from apartheid regime, is a critical factor. The regime promoted discrimination and inequality among the different citizen groups. Indigenous populations were left with a lack of technical and administrative skills and experience.

Any social responsibility programme should be seen as a kick-start for a viable and sustainable new order where human beings can realise their human potential through personal and community empowerment and the acquisition of knowledge and skills.
Also they have to consider:

- Creation of social economic opportunities and alleviation of social-economic needs.

- Integration of the vast majority into the economy requiring a major effort in social and economic development.

Development is an incremental and on-going process that can be defined to include improvements in material welfare, especially for people with the lowest incomes like the majority of South African people. Then ongoing funding to promote economic growth can help to redress inequality through capacity building (empowerment) of individuals and communities in a sustainable way, if policies address the issue in this way.

It is not easy to change the condition of people of lower incomes to make the impact of credit quickly visible in the community. The result of financial loans is a long process from which we can achieve sustainability.

It is also fair to advise, in relation to the proposed amendment of the Usury Act from R6 000 to R50 000, that the consequence of great increase of the credit exemption is to concentrate the capital distribution and reduce the level of distribution across the community. It is a matter of a trade off between more distribution and more concentration of capital. However, it is reasonable to assume that it is necessary to create the impetus to bring banks to penetrate into the micro lending industry.

If poor rural people fear not getting other alternatives they are more likely to reduce expenditure and increase savings. This is true in conditions where households have the minimum to survive in normal daily life. It is a matter of both confidence and expectations. But in South Africa, it would be difficult because of the poorest situation of the people. The poor level of the majority of South African people does not motivate for an increase in saving.

One can conclude by the research results that interest rates ceilings are critical for small business development. Subsidies that let financial institutions lend at reasonable interest rates are crucial in addressing borrowers' financial difficulties.

Adam Smith (1776) states "no society can surely be flourishing or happy or which by far the greater part of numbers are poor and miserable."

5.2.2 Hypotheses 2

Hypothesis 2 was "The circulation of resources in a community is higher in case of lower level of interest rates."

The situation found in the field shows a significant effect of lower interest rates on circulation of resources in a community.
People in a community do not need to go out of their environment to buy food and other products for their daily lives. The alteration of their life is evident. Because of access to loans, people have increased their levels of income. They are able to start small business activities and get some profit, which enables them to pay fees for their children, buy school uniforms and improve their diet. This scenario shows that the lending process is changing life in the community. The impact of lending goes beyond the influence of a single household getting credit. This is the multiplier effect on the community.

However in this analysis, we have to consider the limitations of the evidence because of the lending process is new and has not had enough time to mature.

It is important to notice that in a circumstance of general lack of capital, a higher increase of capital per person will lead to a general concentration of capital on some borrowers and consequently less distribution across the population. This argument is in favour of an interest rate ceiling and a flexible level of exemption from the Usury Act according the sector of micro lending industry. Therefore the regulation has an important role to play in addressing this situation.

5.3 Urban versus rural

It is not easy to compare rural and urban areas because of their specific characteristics and also because of specific perceptions existing around the two. Traditionally among social scientists, concentration has focussed on urban poverty, while the poverty in rural areas has remained invisible or has been considered as a natural part of rural life (Walker, 1978, p.1).

There is in fact considerable variation in the complexity of definition of urban and rural populations. For instance, in Norway a city is a locality with 200 or more inhabitants, while in Japan, a city is a place with more than 50 000 inhabitants (Carter, 1990, p.6).

Many authors, for example Walker, (1978, p.3) advocates that the movement of the rural population to cities results in an increasing concentration of elderly people in the rural areas and as a consequence, an increasing demand for personal social services. This decline in rural population can be explained by a lack of resources and incentives for younger people to stay and pursue a regular life in the countryside. Rural depopulation is unfortunately the predominant trend during the 20th century. So rural areas have fewer people to support the standard services such as post-offices, schools, public transport, etc.

One of the major characteristics evident in rural areas is the lack of regular, cheap bus services and the inequalities are exacerbated by vast geographical locations. Extra costs are imposed due to distance, for example, to shops, and access to public transport or health services may be restricted (Walker, 1978, p.5).[5]

Another important problem in rural areas is related to the difficulties of getting water. This problem is associated with others, like poor public transport and cutbacks in deliveries, inadequate houses, no suitable work and consequently inadequate income. Insufficiencies in health and medical care are also a problem in rural areas as well as unequal allocation of resources compared to urban areas. The majority of workers are basically farm workers. In general the people consist of elder people (pensionist) because of the inflow of retired people from urban areas. Rural areas tend to have a larger concentration of women than urban areas. The productive activities are concentrated in agriculture and forestry; firewood (energy source). These activities are characterised by low paid employment and employment of family members (Walker, 1978, p.6).

The population density is low in rural areas. The scarcity of numbers of schools and public services turnover rates question the level of education and public services offered. Consequently the level of education is low and then more pupils from rural schools are entering unskilled employment and few enter employment involving training (Walker, 1990, p.6).

In short, trying to compare urban and rural we find as mention by many authors that urban areas consist of communities surrounding major cities and areas of industry and mining employment. Urban is characterised by a population engaged especially in the provision of centrally or accessibility

[5] **My personal experience, when doing the research in the rural area of Kildare testified to the problem of transport mentioned above. It was necessary to take three taxis to get Kildare because there was no direct taxis.**

located facilities, such as shop's, banks and professional services. Whereas a rural village is made up of population that is primarily engaged in agriculture (Carter, 1990, p.6).

For example, during my research, after it rained, I found that ever family was working on the land in contrast to my first visit to Kildare. Agriculture depends on the rain. The agriculture is merely for subsistence. The working of the land in rural areas is bound with reciprocal relationships and hence with the neighbourhood or community. Whereas in urban area communal relationship are not as close.

According to data presented from Central Statistic Services (1991) for Mamelodi and Kildare, presented in Chapter 4 of this research, we can understand that although the level of poverty is very high in both sites, in the latter, the situation seems to be worse. This is what precipitates the call for more incentives for business activity in rural areas.

In rural areas, there is more commitment to pursuing specific programmes of small businesses. As mentioned by one of the interviewees, rural people are more willing to pay back their loans. The problem probably is that the market situation is less favourable.

The above presentation led us to understand that it is important to pay attention to the difference between rural and urban when designing and implementing a programme of credit for small businesses. Of course the differences between the two also require differences in the credit system to be adopted. This might be, particularly, in the period of repayment and the amount of money to be lent. By the way, it is important to note that because most of the borrowers either rural or urban employ the money for commercial purposes rather then for productive activities, the characteristic of the loans system might be considered seriously. In terms of development it is advisable to provide incentives for productive activity rather than commercial activity. In this case, the multipler effect as a result because of the credit system can be more visible and useful for the community.

CHAPTER 6

CONCLUSIONS AND RECOMMENDATIONS

6.1 Conclusions

Interest rates are and will remain a very important issue in South African small business finance. The findings of this study leave little doubt on the capital valour of the low level of interest rates on the process of capital access for small businesses and on the multiplier effect afterwards in the community. Subsidies seem to be one important measure in this regard.

It is the author's belief that interest rate ceilings might be considered seriously in the present amendment of the South African Usury Act. However it is important to differentiate by sector of activity rather than a simple generalisation, to make the regulation respond to the real needs of the different sectors and not became a factor of destabilisation in the small business market. Truly, it is important to avoid possible over-commitment from borrowers. This might be accompanied by, a review (evaluation) for example, of Khula performance and by efficient improvement of the financial institution activity.

The taxation policy is another tool to be considered as an incentive for more business activity in rural areas. For example taxation reduction for those willing to start businesses in rural areas can be one of the measures adopted.

It can be reasonably concluded that the major purpose of loans being offered is for consumption, education and small housing. In these two latter cases the process is through individual employer and lender's institutions. This situation points to the importance of being able to target a group through these kinds of loans, and it also points to the relevance of looking for lending for productive purposes. These kinds of loans deserve strong consideration and constitute a big challenge in the South African Micro Lending Industry. Providers must increase this type of loan. Agriculture activities, the main activity of rural areas where the majority of the population lives and to where many retrenched workers and unemployed return, is one important sector to look at in a lending perspective. Many productive activities like carpentry, making blocks of cement; building houses, etc, deserve special consideration from the regulation of interest rate ceilings. This confirms the points previously addressed regarding the need of interest rate ceilings by sector and consequently the need for flexible interest rates.

This conclusion is supported by results found in the field that show some experiences gained in lending for consumption purposes and the fact that retrenched workers with some productive skills returning to their home have little chance to get involved in some kind of activity to help themselves and the community. Any productive activity that they can enrol in can derive positive multiplier effects in the community and then contribute to their personnal and community development. The matter of the high cost of establishing infrastructures deserves further specific research to better understand the situation. It should be reasonable to conclude that in South Africa the experience of small business lending is new and needs to be supported and encouraged generating many more experiences to enable to comparisons with international experiences and derive better insights about the way forward in the South African context. This is emphasised by a draft discussion document, which points out that "South Africa has not yet generated large-scale success stories (such as existing in Bolivia, Bangladesh and Indonesia)" (DTI, 1998, p.3).

Previous international studies and experiences show the importance of group loans to reduce costs of small loans and replace the huge problem of collateral. The issue of group dynamics is critical in this process. It is important to mention the experience of RFF who encourage centres as a result of the concentration of some groups (four to five). This is an attempt to reduce operation costs and to strengthen the potential replacement of collateral in the process. Although in some centres the result is not as good as in other centres, the results generally look good. Ultimately it depends on the loan officer in the field. This exercise needs more exploration and a capacity building process before it will be well developed within communities.

The trend to use short term sources of finance for consumer purposes and to finance the long term requirements of a household like education, housing and fixed assets seems to be a dangerous practice and should be discouraged. This is because the long term does not produce the cash flow immediately. It takes some time. Therefore the borrowers face problems of liquidity in pursuing their business activities and suffer penalties because of arrears in paying their instalments. Borrowers might use a separated specific line of credit for this kind of purpose with specific conditions.

Although the issue seems to be complex, in practical terms it might be considered because it does impact negatively on the financial health of the household. The household will never become prosperous.

The problem of misuse of the credit will never be solved unless a specific line of credit is set up. There is a need for "new legislation to require disclosure of lending patterns, penalise lack of investment in socially and economically productive areas, and make credit discrimination illegal" (DTI, 1998, p.5).

Although previous studies note the important social role that the quick loans offer to society, it is advisable to pay particular attention to that role because of the high interest rate charged. Another reason is the high level of collateral they require. This matter of collateral extends to the banking sector. They also require too much as collateral to offer any loan. The legislation has to address this issue, forcing a review of financial contracts and collateral laws to facilitate and simplify procedures required obtaining loans.

The legislation should encourage the trend of creating new financial institutions like community banks and others to fill the gap existing in the market. It seems that this type of bank could be a good alternative to normal banks. The experience allows one to foresee that these new banks could make a new and appropriate response in making financial services available to small businesses, particularly in informal settlements and in rural areas. New banks seem to be a more workable approach than to seek to transform the existing banks embedded in strong biases regarding small business financing. There are some international experiences from India, Japan and others countries about new banks for small industry, which were discussed in the literature review, in Chapter 2.

However, it is important to realise that movement towards new banks for small business industry must be accompanied with capacity building process. In practical terms we are stressing the need for sustainable growth of the financial system. Considering that such growth must be financed in an orderly and planned manner to ensure the long term financial health of the providers, the findings of this study, which are that providers operate close to the upper acceptable limits of using debt, is evident. It is, by the way, important to consider all aspects of the capital structure of providers and the effect of the interest rates on the cost of capital, to determine properly their needs in financing the growth of the micro lending industry. As a result it would be possible to wider the accessibility to finance for borrowers.

The result of the field study shows that rural and urban area present difference. In rural areas the majority of borrowers are older than in urban areas It is evident that in rural areas people are much poorer and the markets are smaller Borrowers in rural areas present show more of an awareness to pay their instalments than in urban areas. Perhaps the fear of consequent troubles without any alternative solution and the peculiarities of the rural environment can explain this behaviour. The business cycle is much longer in rural areas than in urban areas. Because of this any credit scheme has to consider that. As a result it became clear that rural and urban areas require specific schemes if the intention is to contribute to the development of those areas.

6.2 Recommendations

There is no particular formula that can be presented for such a complex and controversial matter of the interest rate impact on small businesses. However according the evidence, found some suggestions on this issue will be presented:

- The Government should continue to play a role in the interest rates issue by adopting flexible interest rate ceilings as a way of guaranteeing appropriate environments that lead to access to capital for small businesses.
- Specific credit schemes for rural conditions must be established. The business cycle in rural areas is longer than urban areas. As a result there must be a move for the extension of the repayment period for rural areas.
- Because of the economic and market conditions it is advisable that as a complementary measure to interest rate ceilings, taxation and subsidies should be considered.
- Because of particular nature of the providers, the author of the report suggests adoption of a specific level of reference for exemption based on careful consideration of all the critical aspects that could influence the possible impact of the reference level for exemption.

- A plan of needs of funds and respective methods by which it will be financed is of paramount importance. Thus interest rates, which play a *critical role in the funding of decision-making, should be anticipated* and considered. This is to determine the future structure of capital and foresees the level of expected recovery rates. Consequently this is going to ensure progressive and sustainable provision of more resources for small business development and their contribution to the development of local economies.

- Discouragement of the misuse of capital loans must be undertaken by opening lines of credit for a much broader range of needs of borrowers, particularly education. Although it seems that many borrowers do not care about the interest rates charged it might be recommended that every provider within the limits of the area of lending, revise the increased misuse of the capital. This may be operated by a wider dispersal of lines of credit for small businesses.

- The movement towards community banks appears to be a good attempt to contribute to finance access for borrowers, particularly in rural areas, therefore, it should be encouraged.

- *Particular attention must be given to loans for productive purposes* as they may contribute more towards the economic growth through multiplier effects in the community. Therefore particular incentives must be adopted for these kinds of loans.

- The strategy of using group loans was found to be useful because they improved borrower activity and strengthened good recovery rates. Hence the use of group loans should be encouraged. In addition to this training practices have to be promoted.

- Further research should be undertaken to evaluate the impact of interest rates on borrowers and the results on the circulation of resources in communities.

Appendix A

List of the institutions interviewed:

◇ **Alternative Finance Limited (Altfin)**

Puso Matlou - Branch manager JHB

Ben White - Assistant General Manager - Western Region

Lance Cleaver -,Senior Manager - Mpumalanga

Jacky Nteo, Sam G, Gertrude Motaling - Loan officers (JHB)

◆ **Get Ahead Financial Services (Get Ahead)**

Stembele A. - Operational Manager (Pretoria)

Aniki B. - Marketing research Development Officer (Pretoria)

Joe Shebangu - Centre Manager (Nelspruit)

Maweto R. - Branch Manager (Mamelodi)

Margarett B. - Chief loan officer (Mamelodi)

Lucy K., Simon M., Veronica O. - Loans officers (Mamelodi)

◆ **Rural Finance Facility (RFF)**

Kifi Manyoni - Operational Manager (JHB)

Sopphie Serero - Trainee Branch Manager (Nelspruit)

Nomcebo Dube - Loan officer (Nelspruit)

Wellcome A. - Loan officer (Jonkilanga)

◆ **Strategic Enterprise and Economic Development (Seed Foundation) (JHB)**

Susan Lindiwe Tsambo- Marketing & Communications Co-ordinator

◆ **Eccles Associates (Sandton)**

Katherine S. Naughton

- **National Housing Finance Corporation Ltd (NHFC) (JHB)**

  David John Porteous - Senior General Manager Operations

- **Micro Lenders Assnciation (Pretoria)**

  Gerco Engelbrecht

- **EFK TUCKER INC**

  Rudolph Willense - Chairman

- **Deloitte &Touche**

  Rashid Ahmed

- **Alliance of Micro Enterprise Development Practitioners (JHB)**

  Shaida Naidoo- Executive Director

  Gordon Freer - Programme Manager

- **Khula Enterprise Finance (Khula) (Rivonia)**

  Rubin Jafta

- **Nstika Enterprise Promotion Agency (Ntsika) (Pretoria)**

  John Francis- Head of Management & Entrepreneur Development Division

- **Gauteng Provincial Department of Consumer Affairs (JHB)**

  Collecte Cain

- **SANCO (Mamelodi)**

  Eric Magagula -Deputy Chair Person

- **City Council (Mamelodi)**

  Fenhane K.

- **Local Authority (Jonkilanga)**

  Thami Nkosi

Appendix B

Questionnaires

Questionnaire 1 for borrowers:

- What sources do you have to survive?
- Did the credit access you got change your life?
- Who is involved with you in business?
- How did you join the group of borrowers?
- Are you happy to work in a group?
- How did you know about this credit institution?
- How easy was it to be involved?
- How do you repay the loans? What will happen if you do not repay?
- Are you able to pay back the loan?
- Why and for what do you need credit?
- Are you happy with the credit you got and the institution?
- What kind of changes do you suggest to this institution to be more helpful in your businesses?

Questionnaire 2 for financial institutions's representatives:

- What is the opinion of the organisation with regard to the recent proposed amendment of the Usury Act for exemption up to R50 000 of micro lending?
- Do you think that interest rates do have an impact on the micro lending industry? Why?
- What regulatory policy proposals could be suggested to DTI to enhance the micro lending industry?

- Could the micro lending industry lead to possible increases in financial credit for the development of micro enterprise industry?

Questionnaire 3 for local authority representatives:

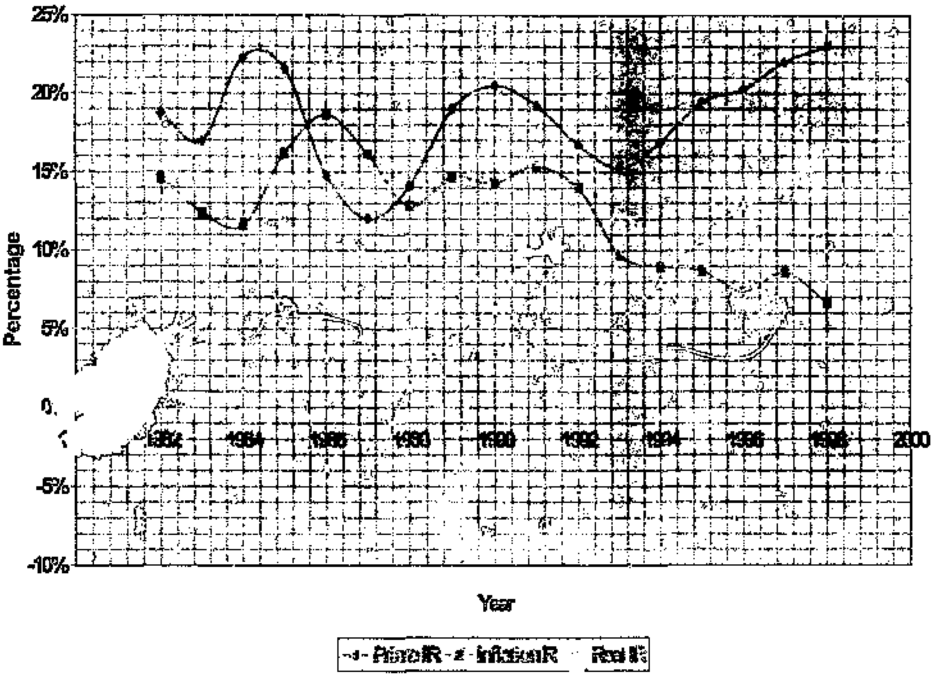
- What is your appreciation on the loans that people receive?
- Do you think that anything changed because of the loan clients received?
- What suggestions do you have to improve the situation?

Appendix C

Prime Interest Rate and Inflation Rate from the SBSA

Year	PIR	IR	Real IR
1982	19%	15%	4%
1983	17%	12%	5%
1984	22%	12%	11%
1985	22%	16%	5%
1986	15%	19%	-4%
1987	12%	16%	-4%
1988	14%	13%	1%
1989	19%	15%	4%
1990	21%	14%	6%
1991	19%	15%	4%
1992	17%	14%	3%
1993	15%	10%	6%
1994	17%	9%	8%
1995	19%	9%	11%
1996	20%	7%	13%
1997	22%	9%	13%
1998	23%	7%	16%

Projection of the Real Interest Rate on base of the Prime Interest Rate and Inflation Rate above from the Standard Bank of South Africa (SBSA)



Appendix D

A sample of interview results

1. Alliance of Micro Enterprise Practitioners (AMEDP)

- The alliance of micro enterprise is one institution oriented towards protecting and assisting SMMEs in South Africa. They are constituted by members interested and involved in the Micro Lending Industry in South Africa. That reason justified their selection for interviews.

- Around the debate of the interest rates' ceiling they recommended exemption to go up from R6 000 to R50 000 to cover the gap that this interval represents. While up to R6 000 there is micro lending institution operating, and from R50 000 the banks operate, nobody is operating in the middle. The proposed amendment is based on the recommendation from AMEDP.

- The AMEDP argue for a financing process where the cost might be recovered not by chance. Hence they propose the application of the real cost price of the loans to recover the cost. That is to maintain the institution and sustain the services they deliver.

- They think that the market situation has changed and DTI must change the regulatory environment. Then they argue for industry self regulation instead of government intervention.

- The AMEDP is concerned with the need for building capacity and the need for co-ordination and better communication between institutions. They consider that DTI is not playing their role in that matter. On the other hand they criticise Ntsika for not performing satisfactory in their role in capacity building towards smal' businesses. For them Khula must review their mandate and decide if they fulfilled their role in helping small business acces to money. Their perception is that Khula does not play an appropriate role in the redistributive process of credit. On the contrary they are, so restrictive that they contribute little to help small business access to finance.

2. Khula (Rubin Jafta)

- Khula is a state owned organisation created to function as guaranty for small business access to capital. They have the responsibility of indemnity up to 60% for loss in the case of business, which has been financed by one of the participating banks.

- In relation to the proposed amendment of the Usury Act Rubin suggests that the exemption from the Usury Act to be increased from R6 000 to R25 000 to businesses for productive purposes. That exemption must involve micro lenders charging comparative low interest rates and not involve the quick loans. This is to give more opportunity to the micro lenders to increase their business activity in the market.

- Rubin Jafta's concern is that if the interest rate for small amounts is not significant and then the level of interest rates is not an issue for borrowers. Moreover the cost of capital is not the problem. The other costs like administrative costs, inflation arrears and so on are the problem for the level of interest rates charged. The point to be worried about is for borrower to get access to money quickly. He point out that although people have been charged 50 to 200% interest they continue to go back to the lenders to ask for more loans.

3 Alternative Finance (Altfin)

- Altifin is a financial institution for housing finance. It was included in the interviews because of the particularity of offering a greater range of loans. Their criteria of repayment are based on salaries. This differs from Get Ahead and RFF, which is confined to personal loans, and the repayment depends on the results of the business activity.

- The argument present by Ben White interviewed in this institution is that the suggested amendment to R50 000 for the level of the interest rate's exemption from the Usury Act is too high. However he agrees that R6 000 is too low considering the actual level of inflation. He suggests, instead, a range between R10 000 to R15 000 as an appropriate level.

- He argues that high levels of interest rate exemptions can lead people of low income to be over committed and thus increase the legal procedures against falters in repayment, instead of helping people to solve their problems. They observe that the low level of education of the market in financial issues is one important aspect to be considered. Therefore the need for market education is necessary. He advocates that without such an approach the economy will face trouble. So it is not appropriate to have a big jump from R6 000 to R50 000. The concern is that such a proposal will benefit mainly the cash loans, in particular, those operating illegally.

- The interviewees also referred to the need for limiting the market determination of the level of interest rates. Although they agree on the market role on the level of the interest rates, he suggests some kind of limitation because the market is not mature. They think that the limitation of interest rates from 45 to 50% would be beneficial to Micro Lending Industry. The levels of interest rates have to be droped down during three years and be increased gradually. The strong argument they make is that loans have to be connected to the level of income. That's a way to make control easier. This should take the stability of the market into consideration.

- The Altfin representative mentioned an important aspect related to bank behaviour. They criticise the bank for being afraid to touch the market by refusing to give loans to small businesses because of being afraid of the risk and cost involved. They have to realise that micro lending plays a big role in expanding the credit market.

- Apart from their daily activities in the Micro Lending Industry, Altfin is planning to be a small bank. The interviewees indicated that it would be a way for them to capture savings and enable the institution to have more liquidity and then have cheaper money to credit loans.

4. Collete Cain (Director of the Provincial Department of Consumer Affairs)

- Collete Cain was interviewed as the person in charge of consumer affairs in the Gauteng Provincial Government. This department is responsible for consumer issues. Because small business activities do affect the level of the household consumption it was important to find out the perceptions of this institution.

- Collete Cain argues for consumer protection. But she suggests such protection at demand side. She argues for more clarity in DTI on small business regulation. She finds little capacity on the DTI side to address that. Collete Cain criticises the proposal amendment of the Usury Act suggesting an increase in the base for interest rate ceilings to R50 000. She thinks that the proposal amendment did not involve all important stakeholders. There is a need to involve the stakeholders. She advises the need for a clear understanding of the role of the stakeholders. This requires a new attitude to be undertaken by DTI. She also questions the capacity of a guaranty of a proper application of such a proposal. Hence she feels that only the cash loans and banks will benefit from the proposal amendment.

- She pointed out that if the level of interest rates were too high, it would lead people to underdevelopment instead of development. She says that cash loans do not help people for real development.

- She thinks that any legislation has to have a clear justification and make sure about the targeting group. So she argues that any regulations have to have a policy basis. The proposal amendment seems not to have a clear policy base.

- She says that the cost of legal procedures is too high to be considered seriously. She also stressed also the need to pay attention to the situation of uneven development as a basis to sustain the regulation policy.

5. Dr Porteous (Senior General Manager Operations in National Housing Finance Corporation Ltd.)

- Dr. Porteous is a manager in the National Housing Finance Corporation. This institution is responsible for the finance process at a national level for housing purposes. In the context of their activities they also operate in the Micro Lending Industry. That is why they were included in the int... for example, operates under this institution.

- He divides the borrowers in three groups. The first group compris... eligible for loans under R6 000. The second group for those between R6 000 and R50 000. The third group are those eligible for loans above R50 000. He thinks that in the present structure of the finance process, the middle group is not covered. For him the middle group is an important portion of the population to be considered. The group accounts by almost 2/3 of the potential population of borrowers.

- He finds sound approach to micro lending been in joint venture with banks to enable better environment for small businesses' development. That is why he thinks that the proposal amendment of the Usury Act from R6 000 to 50 000 is an appropriate way to view the way forward in the present moment. Later on things may change and banks may take over the micro lending industry or the micro lending industry develops small banks.

- He argues against self-regulation. He suggests for a strong consumer organisation to balance the forces between creditor's suppliers and creditors' consumers. However he advises against over regulation as way to get everything under control. When we talk about exemption is important to distinguish between housing and micro enterprise. For housing he thinks that there is nc need of such level of credit exemption from the Usury Act.

- Dr. Porteous during the interview stressed the potential of the Micro Lending Industry as a force for development. He thinks that in real terms micro lending deals with risk as much as the commercial banks do. He points out the need for banks to engage with population needs. The majority of the population does not have access to finance. He points to the code of conduct as an important aspect to be considered in the micro lending industry.

6. Rashid Ahmed (Consultant on Deloitte and Touche)

- Rashid Ahmed is a consultant at Deloitte and Tou This company has been consulting a lot in the small business area. Rashid has a lot of experience in the banking sector. He worked for 10 years at the Standard Bank. During that time he got some experience in the lending process.

- He thinks that exemption does not help. This is going to accommodated a big group of interest and not help the very poor who are unbankable because of their low level of income. He pointed to the monopolisation of the market by the banks. He says that that there is a certain indication that the banks are in a segmentation process indicated by the creation of small banks. This seems to be a channel to attack the micro lending market.

- Rashid Ahmed considers that people do not care about interest rates. They perceive interest rates as something that have to do with the market. He thinks that the interest rates for small business became a minor variable. The problem is a shortage of capital and equipment and the high levels of collateral.

- The interest rates do not matter for micro lending. He thinks that the amount of money lending to borrowers in macro lending industry is too low and does not help the poor. However they do not have alternatives to get more money. He thinks, however that high level of interest rates does not help to start businesses and hinders business development. This is unfortunate because there is no lack of money in the country. The main problem is access to money.

- The existing regulation is too weak. The loans' charts play around without any intervention. According to him there is a need to pay attention to high level of default rate. For example, in housing the loans are used for purpose other than housing. Nobody knows where the money goes.

- He points out that Khula, as an institution does not impact on small businesses. He says a good question to ask is if they have reached the objectives they were created under. He thinks that the requirements they ask for are too strict and that the banks disagree with them and is difficult for borrowers to follow.

7. Puso Matlou (Branch Manager of Johannesburg-Altfin))

- Puso Matlou is manager of Altfin branch in Johannesburg. As we mentioned earlier it is a financial NGO operating in the Johannesburg financial market.

- One condition for a loan is that the borrower has to be employed at least for two years and the age is from 21 to 63 years. The minimal salary is R750. One of the requirements is that the monthly deduction cannot be more than 1/3 of the salary. One difficulty associated with that is that many companies do not accept pension and providence funds as security. He mentions that many of the clients are from government institutions. Others are from private companies around Johannesburg.

- On average, to get a loan takes five working days. He says that they are making a great effort to educate the client about the conditions attached to loans and about the subsequent procedures.

- In general people do not care about the level of interest rates charged. It is only when they start to pay that they feel it as an issue. But then they have no chance to default because the repayment is deducted directly from the salary. So it becames one way of forcing repayment. According to him 85% of the clients are satisfied with the loans they receive. They come back for more loans.

- He argues for a limitation of the interest rates charged because the market is not educated. He is concerned about possible over commitment of borrowers because of increasing the level of exemption. This is going to kill the market because the clients will not be sustainable.

- He thinks that the micro lending is a very helpful for the clients. However he mentions that there are people who can afford but many cannot because the salary base is too low according the conditions for access to loans.

- The purposes of loans are for housing and home improving. They also give loans for personal uses like education and to buy furniture and other long time consumer goods (furniture, TV, stove, etc.). Altfin also offers to pay school fees although most of their clients ask for loans for home improvement. Secondly loans are asked for education purposes and thirdly for furniture.

- For purposes of repayment they consider January to November. December is month off because of Christmas. During April and May they have many teacher clients. Teachers are studying on a part time base.

8. Joe Shabangu

- Joe Shabangu is the manager of Get Ahead branch in Johannesburg. As we mention earlier Get Ahead is a financial NGO. Get Ahead gives loans for small business activities.

- Joe Shabangu mentions that people are not in the same social condition. Because of that, it is not fair that the market should be open for everyone. He thinks that there must be some regulation to help disadvantaged people. According to him the actual situation of the market is that rich people are become more rich and poor people more poor. This is dramatic because there are no jobs.

- To get loans people have to be in a group of 5. This is for security purposes and to make the lending process cheaper. It is expensive to deal with individuals. Each individual has equal responsibility for the group. This also enables some people to start businesses through the support of the group.

- Interest rates are not a problem if compared with "machonisas". The problem of interest rates arises when there is no control of the financial system.

- A clear majority of 99% of the clients are woman and in general they are divorced/separated or widowed. They appear, in practical terms, to have more responsibility. Women in general are good payers. Probably because most of them have growing children and they are more concerned with the negative consequences of non-payment for the household income.

- The level of recovery rate is 90%. Then the business can be self-sustainable. One important component of the process is the community meeting. The bases for formation of the group are to know each other, being a neighbour.

- There is a difference between rural and urban people. It is easier to deal with rural people than urban ones. The clients are much younger in urban areas than in rural areas. They are more unwilling to repay than urban ones. In contrast to the rural situation, many clients from urban areas are employed and use their parents or employers to work in their businesses. They also have a club account as a way to help each other in cases of difficulty.

- While in urban areas the businesses deal more with selling clothes, sewing, selling vegetables and foods, in rural areas the businesses deal with selling meat, traditional beer, dressmaking, pots and (capulanas).

- The money the borrowers get is enough. He thinks that large amounts of loans provides problems to borrowers because they will not be able to repay the loans. It is better to give amounts of money that have a certain guaranty of repayment.

- Get Ahead is moving in the direction to decentralise the management process. Each branch will have its own budget. The loan's officers are from the area were the loan is given.

- Get Ahead is going to transform into a community bank for the future. This is a way for borrowers to save in the bank and allow ordinary deposits to be part of the financial loan process. This kind of bank will be much nearer to the clients, allowing ordinary and illiterate people to be part of the banking system. This will be the kind of bank where poor people will feel comfortable to join.

9. Lance Cleaver (Senior Manager- Mpumalanga)

- Lancer Cleaver is a senior manager of Altfin in Mpumalanga. He is based in Nelspruit. As mentioned earlier Altfin gives loans for housing. However in practical terms the loans are for incremental purposes.

- He thinks that interest rates' ceiling is necessary because the majority of the population can not afford higher rates. However he thinks that the population is more educated now than two or three years ago. Because of that he suggests slight increase in the base of the interest rate ceiling to R10 000 for 1,5 -2 years and then look at another level. He rejects the level of R50 000.

- He argues that interest rates have to follow the rule of supply and demand. But he adds this function in a perfect market condition. The South African situation is not that of perfect market.

- He says that we have to deal with the real market where there are people with access and people without access to finance. Those who have access have experience and do not need protection. And those without access need protection. They are not exposed enough to interest rates. After two-three years we can leave the level of interest rates to the marked condition. During the last two years many people were exposed to credit. They are now more able to look around and seek out cheaper credit.

10. NTSIKA (John Francis)

- Ntsika is a government institution created to provide non-financial assistance to small business. Johan Francis is the head of the Management & Entrepreneur Development Division at Ntsika. He indicated that the Ntsika mission is to give technical support, training and consultation to businesses. He continues to say that they operate through local businesses' service centres.

- He pointed out the need for state intervention in this process. He mentions the experience of Japan of state banks located in critical areas. He also mentions the example of community banks experienced in many countries.

- For him small businesses create a new market and must be encouraged. He referred to the need for revision of legislation. He argues for the need of an different approach to Khula in order to serve businesses. He indicates that Khula is operating like a bank that is not appropriate.

11 Katherin S. Naughton - Eccles Associates

- Katherin Naughton is the representative of Eccles Associates in South Africa. Eccles Associates is an international organisation also consulting in small business activities.

- She points out that the interest rate ceiling is necessary and important but not because of the protection it gives to loans for consumption. These contribute to raising inflation, which is not good for the development of the country, and for small business.

- For Katherin Naughton, the cost of money is the problem. She suggests looking to the Reserve Bank as a supplier of money as critical point to discuss about the impact of interest rate on business. The cost of money is not fixed. Financial businesses tend to raise interest to make more money. Then, she argues competition is the only way to decrease the interest rate.

She also suggests that the level of interest rates is the second aspect to be considered. The main aspect, she stresses, is the access to money. She also thinks that the effect of interest rates is related to the kind of business. According to her for very a profitable business (not productive) the interest rate doesn't matter.

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